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Introduction

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I believe that we should now build on the ideas that have emerged in the large financial centres and we should seek consensus on a co-ordinated approach over the coming months, building on four key elements.

First, that a levy on banks seems likely to be the most practical approach.

Second, that the levy should be designed to go with the grain of necessary regulatory reform not cut across or remove the need for it.

Third, that the levy should support globalisation and avoid double-taxation of international banks.

And finally that proceeds should be for national governments to use, whether to put them aside in a dedicated insurance fund, to repay interventions or to reduce public debt.

Based on these four principles, we now need to work actively in the G20 to forge an internationally consistent approach.

(Gordon Brown, Speech on the Economy
held a Canary Wharf, 10 March 2010)

[The International Monetary Fund is asked to] prepare a report for our next meeting June 2010 with regard to the range of 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.

(G20 Press Communiqué, Pittsburgh Summit, September 2009)

1.1 Introduction

In the wake of the financial crisis, the taxation of the financial sector has become a very charged topic and the object of a number of international policy initiatives most notably that of the G20 (IMF 2010b). The outcome of

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these initiatives and the extent to which they will be coordinated internationally remains unclear but there can be no doubt that the crisis has opened up a significant debate on the taxation of the financial sector including the tax treatment of individuals employed in the sector and the structure of incentive payments.¹

This book originated from a conference held in Milan in April 2009. That conference addressed the issue of what lessons for tax policy could be drawn from the financial crisis. The papers presented at the conference (Chapters 2–6) examined whether tax arrangements in many countries and across jurisdictions may have influenced decision making and been a causal element in the crisis. The general conclusion from these papers was that the tax system had on balance played a minor role in triggering the crisis but that the crisis had served to underscore a number of weaknesses in existing tax systems.

Since then the debate has focused on a number of other issues many of which relate to the use of tax policy to address the problems in financial markets resulting from the crisis:

1. the manner in which the financial sector should 'pay' for its bailout but also the role of accumulated tax losses on financial institutions' behaviour (Chapter 5);
2. should taxes play a role in correcting the systemic externalities associated with 'too big to fail' and more generally the role of taxes in the regulation of the financial sector and their possible coordination with other domains (notably accounting and capital adequacy norms) (Chapter 11);
3. what types of tax are most appropriate for financial institutions and markets ('excess profits' versus 'financial transaction' taxes (Chapter 5);
4. the role of taxation in counter-cyclical and macroeconomic policies (Chapters 9 and 10).

This book attempts to provide a broad overview of these many disparate issues. Apart from certain clearly defined 'one-off' initiatives that have been passed into law, such as the bonus taxes and special levies on banks, the current debate has the character of a 'work in progress'. Because the understanding of what occurred in the run-up to the crisis is being constantly updated and policy proposals have not been finalized, our discussion in many ways is tentative² and can be seen as taking stock of existing knowledge and as a very preliminary assessment of various positions that have been aired in numerous fora.

¹ The IMF opened up a public consultation on the subject <<http://www.imf.org/external/np/exr/consult/2009/index.htm>>.

² For example, a significant reassessment of the background to the Lehman bankruptcy has resulted from the Valukas (2010) report, which appeared on 11 Mar. 2010.

This introduction summarizes the main themes that are raised in this book and highlights why the issue of how best to tax the financial sector will remain high on the agenda of future tax policy debates.

1.2 Did tax policy contribute to the crisis?

1.2.1 *Salient features of the crisis*

A long 'laundry list' of causal factors has been suggested as having caused the financial crisis or contributed to its character and severity, such as:

- the large global macroeconomic imbalances;
- the protracted period of low interest rates and credit boom in the USA and UK;
- the asset bubbles in the housing market in a number of countries;
- the concentration of risk in the financial sector;
- the leverage of households and financial intermediaries;
- the flaws in techniques to measure, price, and manage risk;
- the inadequacy of the regulation of the financial sector;
- the structure of compensation schemes encouraging managers to forsake long-run prospects for short-run return.

While these factors have often been country or jurisdiction specific, the financial crisis has been truly global in nature and has involved significant spillovers between financial institutions and across jurisdictions.

It is interesting to note that taxation and fiscal policy do not appear in the list of major culprits responsible for the financial crisis. There is a consensus that is reflected in the papers presented in Milan that the tax system appears to have played a secondary role, albeit a possibly decisive one in some circumstances, in determining the precise features of certain transactions. The most important appear to have been:

- (a) the deductibility of mortgage interest by households;
- (b) the aggressive use of debt financing in M&A and private equity transactions;
- (c) the use of hybrid financial instruments by financial institutions;
- (d) the use of tax havens to structure tax-efficient securitization vehicles.

In assessing the importance of each of these tax drivers it is important to appreciate their role within the broader dynamic changes under way. In other words, the reason why these tax factors may have fostered a more unstable

financial environment depends heavily on other changes occurring in the financial environment.

1.2.2 Household sector: indebtedness and tax

The US housing bubble played a central role in the financial crisis. It is, therefore, not surprising that the first tax factor that came under scrutiny after the crisis was the tax treatment of residential housing.

The returns to owner-occupied housing, which include the value of using the property (the 'imputed rent') and any capital gains from house price appreciation, are very lightly taxed in most countries. Despite the low taxation of returns to housing, some costs, notably interest costs, are often deductible.

Mortgage interest tax relief encourages the build-up of (gross) housing debt, and there is evidence that countries offering more favourable tax treatment for home ownership do indeed have higher ratios of mortgage debt (Chapters 2 and 4). There is also evidence that mortgages fell significantly relative to home value (in the UK and USA) after reforms that reduced the value of mortgage interest relief. High levels of mortgage debt are also associated with very low savings rates of the household sector (Agell et al. 1995).

However, the provisions relating to mortgage interest tax relief do not appear sufficient to explain the *timing* and *size* of the increase in leverage of the personal sector and the geographical concentration of the increase in leverage across countries. This contrasts with the Nordic Countries' financial crisis in the early 1990s, where changes in the tax system coincided with a very significant decline in housing prices.³ A number of other policy developments as well as changes in the lending practices of financial intermediaries appear to have played a much more significant role in the current crisis,⁴ and any tax effect needs to take account of the complex interplay with these other developments (especially on the regulatory front) as well as some other subtle changes in tax provisions. Even in the Scandinavian case, where tax appears to have played a more significant role in the financial debacle, the build-up in debt by households was driven largely by a prolonged period of unprecedented financial liberalization.

³ Englund et al. (1995) suggest that demand for owner-occupied homes decreased by around 15% including the effects of the withdrawal of interest subsidies. They also estimated that short-run impact on market prices of owner-occupied homes was between 10 and 15%, or roughly half the fall in real prices recorded between 1990 and 1993.

⁴ Poterba and Sinai (2008) calculate the impact of interest deductibility on the user cost of housing in the USA and find that on average this provided a tax subsidy equivalent to around 19% of the user cost. While the subsidy is greatest for high-income households (since the deduction is taken at a higher marginal rate), it is nevertheless around 8% for those with low incomes.

Hemmelgarn et al. in Chapter 3 argue that the tax incentive for homeowners to take mortgages in the United States can be considered as a catalyst in a chemical reaction: the deductibility did not cause the bubble, but it may have favoured the run-up in prices. One example that may illustrate the interaction between taxes and the macroeconomic and regulatory framework is given by the housing policies enacted in 2004 and subsequent years, such as the American Dream Downpayment Act (see Chapter 3). These measures appear to have had a significant impact on US housing market dynamics, as low- and no-downpayment mortgages expanded very markedly. Chapter 3 suggests that the decrease of mortgage downpayments may have given rise indirectly to a tax break because of the asymmetric treatment of personal debt and equity: the cost of personal housing debt is deductible, whereas the opportunity cost of housing equity is not, so the consequence of lower- or no-downpayment mortgages may have been an abrupt decrease of the user cost of housing.

The spread of mortgages, in particular subprime loans, was also helped by more lax regulation of the financial sector and the development of new financial instruments. The technique of securitization, which consists of pooling the loans into an investment vehicle and then selling securities backed by payments for these loans, has received considerable attention in this respect (Chapter 4). This securitization process was itself helped by the emergence of a new class of derivatives that allowed the credit risk to be transferred to a third party: the credit default swaps (CDSs).

The role of tax in these securitizations is difficult to evaluate. However, it is clear that the existence of vehicles allowing for a full pass-through of mortgage payments unencumbered by tax was necessary for securitizations to prosper. As recently argued by Han et al. (2010), there is some evidence to suggest that the differential tax treatment of loans on banks' books (subject to corporation tax) and the exempt status of securitization vehicles may have been a factor for the growth of securitizations. While many vehicles were created on shore, the vast majority of securitizations traded internationally were issued through special purpose vehicles (SPVs) domiciled in offshore centres (Chapters 4 and 8), where tax conditions for structuring financial securities as well as market regulation were negligible (Eddins 2009).

1.2.3 *Corporate sector: leverage*

The role of taxes in corporate financing decisions has long been recognized: when interest payments are deductible against the corporate income tax (CIT) but returns to equity are not, then, all else being equal, firms will have an incentive to issue debt until the expected marginal tax benefit is just offset by the marginal increase in expected bankruptcy costs. These preferences for debt over equity can be mollified in the presence of personal taxes, but in practice

tax systems appear to favour debt over equity finance. This is particularly true if exempt investors tend to be the dominant source of external finance, as has been increasingly the case in recent years.

The tax advantage to debt appears to have been decreasing over time as a result of the generalized decline in inflation rates as well as statutory corporate tax rates across countries (Chapter 2). At the same time, other tax factors may have led to an increased reliance on this form of financing, such as the elimination of imputation systems in most European countries and the greater reliance on international capital markets where various forms of tax-exempt investors dominate bond markets.⁵ The extent to which these developments have mattered varies from country to country.

Changes in debt ratios of the non-financial corporate sector in the years immediately preceding the financial crisis do not show a clear pattern. According to some measures, the leverage of the non-financial corporate sector appears to have increased somewhat in the UK and the euro area in recent years (2005–8) following a period of stability in the 1990s (BIS 2009). By contrast, the leverage of the US corporate sector has remained unchanged. On the basis of these observations there is a broad consensus that the tax advantage afforded to debt did not contribute to the crisis.

However, there are two elements that deserve attention in assessing the importance of the tax advantage to debt in affecting the potential systemic weakness of the corporate sector. First, the absolute *level* of indebtedness, rather than *changes* in indebtedness, is what matters in terms of systemic risk. As highlighted in Chapter 2, when firms borrow, they are likely to internalize the expected bankruptcy costs they themselves incur but not the impact of their own failure and default on others (effects that are not present in the use of equity finance).⁶ As a consequence, debt ratios may be inefficiently high from the point of view of the society as a whole. These externalities are likely to be especially large for financial institutions, given their systemic importance and the (explicit or implicit) government's guarantees on bank deposits or other debt. While little is known on the magnitude of externalities from increased leverage, there is evidence that high leverage is correlated with greater output losses in bad times: Davis and Stone (2004) find that higher debt–equity ratios are associated with greater post-crisis output declines, and IMF (2008) that the cumulative output loss following periods of

⁵ Other factors such as cross-border arbitrage activity in equity markets suggest that the tax privilege of debt over equity may not be so significant.

⁶ Chapter 2 also argues that there may also be strong effects on the balance of payments: preferential tax treatment of debt can provide an implicit subsidy to corporate and household borrowing, including from abroad, so increasing vulnerabilities through the capital account. The authors suggest that this might have happened in Latvia: the implicit corporate-level tax subsidy made the cost of investments financed by borrowing about 130 basis points lower than it would have been in the absence of tax.

financial stress tends to be larger the greater the run-up in non-financial corporate debt before the onset (see Chapter 2).

The second element of systemic relevance is that leverage ratios tend to be set to withstand external shocks based on historic experience. One area where such an approach may have given rise to potential problems in recent years is that of leverage buyouts, which rose to historic highs in the build-up to the crisis (see Chapter 2). The possibility of exploiting higher levels of leverage in target (and potential target) companies to achieve tax savings appears to have been in many instances a contributing motivation to the value of the transactions. The benefits of the tax shield depended on the assumption that revenues would grow in line with past experience.

In summary, while tax-induced behaviour of the non-financial corporate sector does not appear to have been one of the causes of the crisis, the high levels of indebtedness of some sectors may have exacerbated the real effects of the financial crisis. Keen et al. in Chapter 2 and Shaviro in Chapter 7 discuss several methods for eliminating debt bias, and more generally making the debt–equity choice tax neutral.

1.2.4 *Financial sector: regulatory and tax arbitrage*

Formally, the financial choices of financial institutions and non-financial corporations are affected by the tax system in the same way (Hanson et al. 2011). However, the high profitability of financial institutions in the years preceding the crisis increased the effective CIT rate, making the tax incentive to debt even stronger than for many non-financial corporations.

In the financial sector the tax bias to debt runs counter to regulatory objectives, which usually entail an implicit penalty to debt. Chapter 2 suggests that the tension between regulatory objectives and tax incentives has fostered the emergence of devices that enable debt-like instruments, attracting interest deduction, to be included in Tier 1 capital.⁷ Prominent among these are trust preferred securities (TruPS), which accounted for a large share of hybrid issues in the USA by both domestic and foreign financial intermediaries. There are two strategies to deal with this tension. The first is to introduce specific measures to close possibilities of this kind. However, if the underlying tax bias remains high, there will be a strong incentive to find other ways of achieving the same end. The second is to reduce the distance between tax and regulatory concepts and definitions.

⁷ Basel guidelines allow up to 15% of Tier 1 capital to be in the form of hybrid instruments that may attract interest deductions—in itself suggestive of the tax bias to debt finance that banks face (see Ch. 2).

Both strategies should be evaluated by taking into account that tax policy pursues objectives that are largely different from those of regulatory and accounting practices. There are obvious advantages in terms of administrative and compliance costs in applying common definitions and concepts for tax and accounting reporting, and corporate governance may also benefit if tax and book profits are more closely aligned (Desai et al. 2007). However, the most accurate measure of current income is not necessarily the best tax base. There may, for instance, be several good reasons for allowing accelerated depreciation or full expensing of investment for tax purposes, and provisioning may be best treated differently for accounting purposes than for those of assessing taxable income (see Chapter 2).

1.2.5 *New financial instruments and tax arbitrage*

The difficulties in measuring pricing and managing risk are greater for new financial instruments. Differential taxation of dividends, interest, and capital gains creates many inconsistencies in capital income taxation (see Chapter 7). Tax inconsistency can be exploited through the ability of derivatives to replicate a portfolio in a variety of ways and to expand the opportunities to tailor the nature of the payments to the tax preferences of the investor (transforming it into lightly taxed capital gains, for instance).⁸ However, most observers believe that tax played only a secondary role in encouraging the growth of the derivatives markets (Chapter 8). One important reason why tax planning may not have borne greater responsibility for the derivatives explosion, at least in the USA, is that tax law requires businesses that qualify as dealers in securities to use mark-to-market accounting with respect to all inventory items, and to treat all gains and losses on such items in a consistent way. In Chapter 7 Shaviro also notes that companies often used the same carefully structured derivatives transactions to achieve several objectives at the same time: minimize tax liabilities, manipulate reported earnings, avoid regulatory constraints, and minimize the effectiveness of investor oversight. In these circumstances, tax considerations, standing alone, may not have made a large difference, even though they clearly encouraged the underlying transactions.

A more direct connection between new financial instruments, tax, and the crisis has been suggested by Eddins (2009). He argues that collateralized debt obligations (CDOs) organized as pass-through entities became especially attractive because their owners entered into CDSs with sellers that could treat default losses as ordinary loss, while the CDO has pass-through tax treatment and therefore would have to treat defaults as capital losses. By

⁸ See Alworth (1998).

attaching the expected losses to the mark-to-market seller of the swaps, the CDO tranches allowed more tax offsets, thus providing a higher after-tax expected rate of return. The strategy was especially advantageous for the riskier tranches with higher expected default rates (Slemrod 2009). Ceriani et al. in Chapter 4 provide a detailed account of this tax arbitrage, highlighting the role played by CDSs. Further research is still needed to understand the real impact of the tax factors in the securitization process. While there is little denying that such arbitrage incentives may have existed, their importance appears difficult to assess in practice.

1.2.6 *Compensation schemes*

The dramatic rise in bonuses and stock option remuneration plans in the financial sector has been among the most debated aspects of the crisis. It is a common belief that stock options and other stock-based forms of remuneration are tax favoured compared to cash compensation. Tax rules for employee stock options are complex and vary substantially across countries and schemes. Ceriani et al. in Chapter 4 provide a detailed analysis of such provisions in OECD countries and come to the conclusion that there is no general tax preference for stock option plans once both employee and employer taxes are taken into account. Nevertheless, they argue that in the USA there is evidence of a preferential tax treatment on the employer's side, which, in conjunction with other factors, may have contributed to the success of stock-based remuneration plans. In other cases, it is possible that a tax preference emerged as a consequence of a unilateral perspective, with the favourable tax treatment at employee level prevailing over corporate tax considerations.

A somewhat different set of issues arises in the case of private equity and hedge fund managers, who receive most of their compensation as 'carried interest' ('performance fees'), subject, in some countries, only to relatively light taxation as dividends or long-term capital gains. Some have criticized this approach on the basis that it entails taxing managers at inappropriately low rates on what is effectively labour income (see Chapters 2 and 8).⁹ In the eyes of these same critics, the growth of 'hedge funds' and 'private equity' firms would appear to be driven in part by these tax considerations.

The basic argument used to support the recharacterization of income is that carried interest is compensation for performing a service. The sponsor (general partner or manager) is analogized to a money manager, who determines how best to invest a client's funds. Accordingly, the carried interest should be taxed

⁹ If this income were taxed as earnings, however, coherence would require that a corresponding deduction for payment of compensation be available to other partners—enabling an increase in the pre-tax remuneration of the fund managers.

similarly to risky returns given to other service providers, such as stock, stock options, or royalties. Indeed, investment advisors' fees are already taxed as ordinary income. This is the case, even if the fees are contingent on performance. For example, if investment advisors receive equity compensation, say in the company that employs them, typically either ordinary income-tax treatment or the principles governing options apply. According to this view, the funds remain the investor's funds. The investor gets taxed on the gains or losses in the funds and potentially can deduct the fees paid to the advisor (Bankman 2007).

According to others (Weisbach 2008), the structure of a private equity partnership does not perfectly fit this analogy. Typically, an investment advisor is not treated as owning the funds that are invested. Instead, the investment advisor is merely the agent for the investor. In a private equity partnership, the partnership is the owner of the funds and not merely an agent for the investors. An alternative way to view the activities of a sponsor of a private equity fund is as an entrepreneur who raises capital to make investments. The form used for raising capital is a limited partnership in which the sponsor is the general partner and the capital providers are limited partners. The limited partners are paid a market rate of return for their provision of capital and have no more involvement in partnership operations than any third-party provider of capital. Under US law, anyone who makes an investment and holds it as a capital asset, even if made with third-party capital, receives capital gain or loss on the investment. Accordingly, changing the tax treatment of general partners would have wider-ranging implications than simply affecting private equity. Another analogy used by supporters of the capital gains treatment of carried interest is that it is given to anyone buying shares through a margin account and profiting on the sale is using in part someone else's money and his or her own effort and ideas about stock valuations to make money.

The discussion of carried interest highlights two key problems in taxing capital income: the distortions to behaviour induced by differences in tax rates and the difficulty of distinguishing labour from capital income. In this as other areas, incentives to income shifting are unavoidable and give rise to complexity. As argued by Weisbach (2008), there is simply no general method of making this distinction, and attempts to do so are complex and give rise to other forms of tax avoidance.

1.3 Implications for tax policy

The fallout from the financial crisis and the impending budget deficits resulting from government bailout and counter-cyclical interventions has

prompted a series of policy initiatives that extend the remit of tax policy beyond mere revenue collection.

Three conceptually distinct areas have attracted the attention of policy-makers:

1. special taxes on the financial sector to recover the costs incurred for the bailout;
2. taxes to correct for distortions (particularly of a systemic character) resulting from the safety net that applies to the financial sector;
3. problem areas with the taxation of the financial sector, which have been highlighted by the crisis (VAT on financial services, the interaction with accounting and regulatory definitions of income, anti-avoidance measures in particular with respect to tax arbitrage).

These topics are not disjointed, and in some instances potential policy prescriptions overlap with regulatory measures (see Chapters 5 and 11).

1.3.1 *Special levies on the financial sector*

Initially much of the policy debate was driven by the desire to placate public anger over the costs of the bailout measures. One response was to limit the bailout expenses by reappropriating windfall profits and rents in the financial sector. This approach is much in the same spirit (albeit with different implications) as the suggestions coming from the international supervisory and regulatory community.¹⁰ The main objective is to raise revenues from those institutions and their stakeholders that have benefited most from government intervention.¹¹ These proposals have taken various forms.

1.3.1.1 THE OBAMA PROPOSAL

Some proposals attempt to achieve both efficiency and revenue objectives. The US government proposal for a Financial Crisis Responsibility Fee (FCRF) at a rate 0.15 per cent on financial firms' liabilities provides a prominent example. It has been presented both as a corrective device¹² and as a means 'to compensate

¹⁰ 'It is imperative that these profits be retained in financial institutions to rebuild capital... The international supervisory and regulatory community is agreed that restricting dividend payments, share buybacks and compensation rates are appropriate means to these ends' (Financial Stability Board 2009: 2).

¹¹ Some observers, in particular of the US package, have noted that a large number of the banks that are targeted for special tax treatment have already repaid the loans extended under the TARP programme and that a number of non-financial corporate entities should also in theory be subject to a special levy.

¹² 'As it would be based on an institution's size and exposure to debt, it would also further the Administration's financial reform goals by providing a check against the risky behavior that contributed to this crisis' (Office of Management and Budget 2011: 39).

taxpayers fully for the extraordinary support they provided'.¹³ In essence, the fee would apply to the largest financial firms with consolidated assets exceeding \$50 billion. Under the initial proposal the base for the tax would be the firm's assets less Tier 1 capital and Federal Deposit Insurance Corporation (FDIC)-assessed deposits. In essence, the tax would apply to financial firms' funding in wholesale markets, which in the view of many was the engine behind the build-up of leveraged risky portfolios. It also appears to be closely related to the ideas put forth by Paul Volcker to limit proprietary trading activities of commercial banks subject to the 'safety net' and more generally the systemic risks arising from maturity mismatches (Hanson et al. 2011).

A similar approach has been taken by the European Council. In March 2010 the Council agreed that 'Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk' (European Council 2010: 6). By mid-2011 a number of special levies and taxes on financial institutions had been actually introduced in ten Member States (Table 1.1), and four other countries had announced the introduction of similar duties. However, no clear pattern can be detected in the European experiences, as tax rates and bases differ considerably.

1.3.1.2 THE TAXATION OF BONUSES

Other proposals aim mainly to achieve revenue and fairness objectives, as well as a means to support indirectly bank recapitalizations or a retroactive measure for banks that received state aid. These motivations were given for the tax on bonuses introduced in a coordinated move by the UK and France in 2009. The UK bank payroll tax applied to banking groups (including building societies) and was levied at a rate of 50 per cent on all discretionary and contractual bonus awards, to the extent that the bonus exceeded £25,000. It took effect from the time of the announcement, on 9 December 2009, until 5 April 2010. The French tax applied to bonuses, including deferred payments and awards of stock as well as cash.

Some interesting lessons can be learned from the UK and French bonus tax experiment. The first one is that the two governments were well aware of the potential consequences of the tax on the location of financial services as shown by the effort to coordinate their policies and by the one-off nature of the levy.¹⁴ The second is that the tax, while formally applying to labour income, appears in many instances to have been paid out of profits (via a grossing-up of pre-tax compensation). The tax appears to have raised revenue for £2.5 billion, an amount about five times larger than the government initial

¹³ Office of Management and Budget (2011: 39).

¹⁴ In the British case, the tax on bonus is only partly one off, as from 6 Apr. 2010 the top marginal rate of the personal income tax was raised from 40% to 50% for income above £150,000.

Table 1.1. Financial levies and taxes in the European Union, 2011

Country	Rate	Base
Germany	<p>Progressive fee for liabilities:</p> <ul style="list-style-type: none"> • 0.02% for liabilities under €10bn; • 0.03% over €10bn; and • 0.04% above €100bn <p>Flat fee for derivatives</p> <ul style="list-style-type: none"> • 0.00015% <p>Capped at 15% of credit institution's annual profit (after tax)</p>	<ul style="list-style-type: none"> • Liabilities excluding capital and deposits • Derivatives (notional value)
France	0.25% of the capital requirements (based on Risk weighted assets)	Risk-weighted assets
Austria	<p>Progressive levy:</p> <ul style="list-style-type: none"> • no levy for base under €bn; • 0.055% for base over €1bn; and • 0.085% for base over €20bn <p>plus 0.015% on the volume of all financial derivatives</p>	Unconsolidated balance-sheet total excluding subscribed capital and reserves, secured deposits, and certain liabilities to banks, provided they are necessary to fulfil liquidity provisions plus add on for financial derivatives on trading book
Portugal	<p>0.05% on banks' liabilities</p> <p>0.00015% on off-balance-sheet derivatives</p>	<p>(i) liabilities excluding Tier 1 and Tier 2 capital and insured deposits (only the amount effectively covered)</p> <p>(ii) notional value of off-balance-sheet derivatives will also be 'levied' (excluding those used for hedging)</p> <p>For both cases, the amount on which the levy will be calculated corresponds to the annual average of each end-of-month balance.</p>
Denmark	Ex post levy depending on the need but annual contributions capped at 0.2% of covered deposits and securities	Covered deposits and securities
Hungary	<p>Progressive levy:</p> <ul style="list-style-type: none"> • 0.15% below and • 0.5% above HUF50bn 	Balance-sheet total corrected for interbank loans
Sweden	<p>0.018% for 2009 and 2010</p> <p>0.036% after 2010</p>	Liabilities excluding equity capital, debt securities included in the capital base, group internal debt transactions between those companies paying the fee, and debt issued under the guarantee programme
United Kingdom	<p>1 Jan. 2011–28 Feb. 2011: 0.05% for short-term chargeable liabilities and 0.025% for long-term chargeable equity and liabilities.</p> <p>1 Mar. 2011–30 Apr. 2011: 0.1% for short-term chargeable liabilities and 0.05% for long-term chargeable equity and liabilities.</p> <p>1 May 2011–31 Dec. 2011: 0.075% for short-term chargeable liabilities and 0.0375% for long-term chargeable equity and liabilities.</p>	Liabilities excluding Tier 1 capital, insured deposits, policy holder liabilities, and assets qualifying for FSA liquidity buffer

continued

Table 1.1. *Continued*

Country	Rate	Base
	1 Jan. 2012 onwards: 0.078% for short-term chargeable liabilities and 0.039% for long-term chargeable equity and liabilities.	
Latvia	0.036%	Liabilities excluding equity capital, deposits subject to a deposit guarantee scheme, mortgage bonds, and subordinated liabilities that are included in equity capital as subordinated capital
Cyprus	0.095% on the overall level of deposits in Cyprus (see base) for the years 2011 and 2012. Capped at 20% of credit institution's taxable income for the two years 2011 and 2012.	Overall level of deposits (of residents and non-residents) in Cyprus, excluding the interbank deposits of credit institutions operating in Cyprus. The tax imposed for 2011 will be calculated on the basis of deposits at 31 Dec. 2010. Respectively, for 2012, the tax imposed will be calculated on the basis of the deposits at 31 Dec. 2011.

Source: Economic and Financial Committee (2011).

estimate.¹⁵ The high tax yield provides evidence of the choice of many banks to absorb the cost by 'grossing up' their bonus pools.¹⁶ The motivations for the 'tax shifting' in the UK appear to originate in the 'mobility' of skilled labour (Radulescu 2010). Shareholders appear to have borne the tax partly to reduce the impact of a higher top marginal tax on their globally mobile employees. This desire to maintain a UK presence may be suggestive of the existence of locational rents associated with a London presence. The nature of these and the extent to which they are durable over time are not clear.

Tax shifting raises two issues. The first one is related to the effect of the tax on bank capitalization. To the extent that the tax is borne by banks' profits through grossed-up bonuses, the levy may have a negative effect on bank capitalization, thereby running against the regulatory objective of strengthening the capital base of banks. The second is whether a direct levy on banks' profit may not be a more efficient way for allowing the financial sector to repay the cost of the bailout.

¹⁵ Brooke et al. (2010).

¹⁶ George and Megan (2010). There is also anecdotal evidence that some bank had planned to raise its base salaries for managing directors and others in order to make up for lower bonuses (Schaefer et al. 2009). The discussion about the extent of the tax revenue windfall does not appear to have taken account of the reduction in the corporate tax base associated with higher gross compensation.

1.3.1.3 EXCESS-PROFITS AND 'HIGH-PROFITS' TAXES

A possible candidate in this respect is an excess-profits tax. There are several types of excess-profits taxes. In the USA an excess-profits tax was levied several times during wartime periods between 1917 and 1953.¹⁷ The various taxes implemented in this period may be classified in two broad families: the first, technically known as a war-profits tax, was designed to recapture the excess over standard profits that an individual corporation would have earned in the absence of defence- or war-induced expenditures; the second, frequently identified as a 'high-profits' tax, is based on the excess over some presumed reasonable standard rate of return on invested capital (Lent 1951). High-profits taxes are also similar to resource rent taxes such as the petroleum revenue tax in the UK or the Australian petroleum resource rent tax (Fraser 2002).

A high-profit tax may achieve the objectives of the bonus tax and the FCRF: it places the financial burden of the bailout on the institutions that have benefited most and is a means to tax 'rents' in the financial sector. To prevent the avoidance of the tax by the distribution of a high bonus, compensation above a given threshold should be added back to profit. Similar levies have recently been proposed by Keen et al. (2010) and by Kleinbard and Edgar (2010).

The effects of a high-profit tax on incentives depend on the manner in which it is implemented. There are two crucial issues. The first concerns whether the tax operates as an additional levy or as an allowance for corporate equity (ACE). In the former case, the excess-profit tax would apply only on profits in excess of a threshold amount, whereas the standard (normal) return on capital would be taxed at the general statutory rate. It is easy to show that this would leave existing incentives to capital structure unchanged, since at the margin debt equity decisions would be driven by the standard rate of tax on 'normal profit'.¹⁸ Furthermore, an additional levy might lead to greater risk taking if the excess return were not a pure rent but a return to risk taking (Kaplow 1994). By contrast, under an ACE the cost of debt and equity capital would be the same. This would favour the recapitalization of financial institutions and potentially offset the effects on greater risk taking resulting from the higher rates of tax on the excess returns.

In addition, an ACE tax could be aligned with bank regulation. To the extent that the standard rate of return is calculated on regulatory (that is, Tier 1) capital, the high-profit tax may provide a tax incentive to increase regulatory capital (see Chapter 2). A further advantage of an excess-profit tax

¹⁷ The first Canadian experiment with a corporation income tax, enacted in 1916, was also based on the high-profits principle.

¹⁸ A recent example of such an excess-profits tax was the Italian dual income tax (DIT). Under this arrangement, however, the normal return on equity was subject to a rate below the standard rate of tax. See Alworth and Lovisolo (1998) and Bordignon et al. (2001) for a discussion of the incentives in the context of cost of capital framework.

of the ACE type is that it could be implemented as a structural reform rather than a temporary or one-off measure and can be coordinated with a more general attempt to reduce the debt bias of the corporate tax.

Under current circumstances, the introduction of high-profit taxes or additional levies would need to take account of the stock of losses carried forward by many financial institutions (see Chapter 8). Taxpayers would benefit from a shift to an ACE the higher the excess-profit tax rate (relative to the ordinary rate) and the greater the size of the losses.¹⁹

1.3.2 *Correcting market failures*

Broadly speaking, the financial sector is prone to two types of problems requiring correction: (1) distorted incentive structures and undesired behaviour of economic agents (moral hazard) and/or (2) externalities within the financial sector (the failure of an institution propagates other financial intermediaries) and from the financial sector to the real economy (systemic risk).²⁰ Corrective taxes are part of wider array of policy instruments, including banking supervision, the application of capital requirements and fees, typically to pay for deposit insurance, as well as general regulation of financial markets by both governments and financial intermediaries themselves (see Chapter 11).²¹

Proposals to utilize taxes to correct for moral hazard and externalities are relatively new and apply both to economic agents and to financial market transactions. They aim to correct different distortions but appear to have the overarching aim of reducing the importance of the financial sector (see Chapter 6). It is inevitable that such taxes may also provide important sources of revenue, and the border line between revenue collection and corrective objectives often tends to be blurred.²² Moreover, in this discussion the difference between 'user charges', capital requirements, and taxes is very tenuous, and typical revenue authorities may not ultimately be responsible for administering the 'tax'. Hence the role of corrective taxes cannot be divorced from other measures aimed at safeguarding the soundness and resilience of the financial system.

1.3.2.1 PRUDENTIAL REGULATION

Prudential regulation of financial institutions takes the form, on the one hand, of solvency or capital adequacy ratios, which aim through the imposition of minimum standards to prevent the failure of individual institutions

¹⁹ A solution to this issue would be to allow loss carry forwards at the pre-ACE statutory rate.

²⁰ There are also many positive externalities resulting from well-functioning financial markets (Levine 1997).

²¹ For example, futures markets have a number of features, such as collateral arrangements (margin), that are meant to safeguard the clearing house against a default by one of its members.

²² This close connection was already apparent in the previous discussion regarding ACE.

(Chapter 11). On the other hand, prudential regulation aims to prevent liquidity crises resulting from the mismatch between banks' assets and liabilities and the potential risk of bank runs; the most common instruments used for this purpose are implicit or explicit deposit guarantees, especially for retail deposits. Demand deposits are explicitly or implicitly insured in most countries up to some threshold amount per individual (or deposit account). In most cases, the capital in these deposit insurance funds is the reserve built up over time through the collection of insurance premiums from banks that receive the benefits of deposit insurance.

While the appropriate form of deposit insurance schemes has been the subject of long-standing debates, the financial crisis has highlighted the need for deposit insurance-related reforms that would improve the efficiency of the financial system. As shown by Pennacchi (2009) and Acharya et al. (2010), FDIC deposit insurance premiums in the USA have either been risk insensitive or relied only on individual bank failure risk. They have never focused on *systematic* and *systemic* risk.

Pennacchi (2009) argues that fair market deposit insurance premiums should contain a *systematic* risk premium in addition to expected losses.²³ If a deposit insurer does not include a charge for systematic risk when setting premiums, insured deposits will be subsidized relative to other forms of uninsured funding. This leads to financial system distortions that excessively expand deposit insurance and encourage banks to make investments that have extreme systematic risk.²⁴

1.3.2.2 SYSTEMIC RISK: TAXES, USER CHARGES, CAPITAL REQUIREMENTS

However, the charge for systematic risk that accounts only for the skewness in bank failure distribution is not sufficient to internalize the external effects of a single bank failure over the financial and economic system as a whole (*systemic risk*²⁵). As argued by Acharya et al. (2010) and Hanson et al. (2011), when a bank with insured deposits fails, the deposit insurance fund takes over the bank and sells it either as a going concern or piecemeal. During periods of

²³ Pennacchi (2009) reviews empirical evidence that firms' actual credit spreads on uninsured debt contain, in addition to an expected loss component, a significant systematic risk premium. Thus, these uninsured debt holders, who can be viewed investing in default-free debt along with underwriting debt insurance, earn average returns greater than a holder of only default-free debt.

²⁴ Duffie et al. (2003) and Falkenheim and Pennacchi (2003) provide techniques for estimating fair deposit insurance rates for privately held banks.

²⁵ Systemic risk is a negative externality and is defined by the extent of propagation of an initial shock (failure of one institution) through the financial system. Systemic risk is sometimes described as a form of (financial) pollution. However, the analogy with environmental externalities is imperfect, since the amount of systemic risk is endogenous to the reaction function of the public sector. In the financial sector, the bigger the accident, the higher are the chances to be rescued.

widespread bank failure, it is difficult to sell failed banks at attractive prices because other banks are also experiencing financial constraints.

In particular, the failures of large banks lead to greater 'fire sale'²⁶ discounts (Shleifer and Vishny 2011). Acharya et al. (2010) note that this event may generate a significant pecuniary externality with adverse contagion-style effects on other banks and the real economy. As a consequence, the resolution of large banks is more costly for the deposit insurance regulator, because the liquidation of large banks entails both higher direct losses and higher indirect losses owing to contagion effects. This suggests that higher premiums per dollar of insured deposit should be charged to large banks compared with that for small banks.

Finally, forbearance during systemic crisis creates a moral hazard problem as banks have an incentive to herd and become interconnected to increase their chance of a bailout. To discourage banks from excessive correlation in their investments the incentive-efficient premium should be higher than the actuarially fair premium and should increase in systemic risk (Acharya et al. 2010).

To summarize, the 'user charges' that can be used to correct for distorted incentives and for externalities can be decomposed into two components. The first is akin to the FDIC insurance fee and should cover the expected cost of failure for each single institution, where the expected cost takes also into account systematic risk. The second component should measure the external cost of failure and should also discourage moral hazard because of the implicit insurance to institutions that are deemed to be 'too big to fail'. This second component would be essentially Pigouvian, aimed at making banks internalize the negative systemic effects of their behaviour. Various alternative proposals are currently being debated.

1.3.2.3 FEES BASED ON THE COMPOSITION OF LIABILITIES

The development of the 2008 financial crisis has confirmed that the scale and speed of liquidity runs are the primary causes of propagation. Banks that rely excessively on short-term uninsured funding contribute to 'fire sales' and to contagion effects (Hanson et al. 2011). Perotti and Suarez (2009) propose a system of liquidity risk charges for correcting the negative externalities caused by banks' excessive reliance on short-term, 'uninsured' funding. As Pigouvian taxes they would complement deposit insurance charges, without creating any explicit commitment to liquidity support. A unit of short-term funding should pay a tax proportional to its marginal contribution to a bank's contribution to systemic vulnerability. A general approach would require the estimation of the systemic contribution of many bank characteristics (Adrian and Brunnermeier 2008).

²⁶ The liquidation of securities by financial intermediaries at the same time as competitors.

An alternative approach discussed by Weder Di Mauro (2010) proposes that the tax base should be composed of all liabilities, excluding insured deposits (since they are already insured) and capital. The tax rate should vary with the size of the externality. The degree of systemic relevance could be estimated based on a series of indicators, which would include measures of size, interconnectedness, and complexity. These indicators could then be compressed (with a simple average of the ranks) into a risk score. Each risk score would be assigned a tax rate.

The tax rate should be set at such a level to eliminate the implicit subsidy to systemic institutions. There are several approaches that would help establish at least a range for the value of the subsidy. Weder di Mauro (2010) suggests measuring the subsidy by comparing the cost of the funding of small and large institutions before and after the 'too systemic to fail policy' was officially established. The idea is that the tax rate should eliminate extra profitability resulting from being able to tap capital markets with a 'too-systemic-to-fail' guarantee (see also Drehmann and Tarashev 2011).

1.3.3 *Transaction taxes*

The introduction of a financial transaction tax (FTT) as a tool to stabilize financial markets and improve their functioning is one of the policy options that are being discussed for correcting potential market imperfection (Chapter 5 and Matheson 2010) In the most recent discussions on proposals for an FTT, it is argued that such tax could solve three problems at the same time:

1. stabilize the financial markets by reducing speculative and technical trading, especially in the derivatives market by increasing transaction costs;
2. raise substantial tax revenue while creating only small distortions in the real economy,
3. serve as a contribution of the financial sector to the financing of bailout costs caused by the financial crisis.

FTTs have existed for a long time in various guises and represent a significant source of revenue in many countries (especially in Latin America). Discussion of their use as an instrument to correct for 'distortions' in the financial markets, especially after economic downturns, started with Keynes's reflections (1936) on stock markets following the Great Depression. The idea of an FTT is also linked to the proposal of James Tobin on an international uniform tax on all spot currency conversions. Tobin (1974, 1978) argued that the increased mobility of private financial capital—especially after the end of the Bretton Woods system—might lead to excessive shifts of funds that create real

economic costs for national governments and economies. Tobin reasoned that the tax would increase the effectiveness of domestic monetary policy.

The proponents of an intervention argue that the tax could improve the functioning of financial markets by reducing speculative short-term activities, which they consider as a reason for price volatilities and price bubbles (Chapter 5 and Matheson 2010). It is argued that potentially harmful financial activities with a high amount of transactions per day would be reduced even by a very low tax rate, but long-run investments would not be distorted by such a low tax rate because of the low frequency of such transactions. Hence the debate on FTTs has generally narrowed down to the question of the influence that transaction costs on trade volume, and price volatility, and if they can serve as a corrective device to reduce the number of allegedly harmful short-term traders.

The theoretical literature does not provide clear-cut answers. The various empirical studies fail to detect a strong relationship between an increase in transaction costs (via either taxes or other means) and the functioning of markets. Most studies find that trade volume is reduced, but the effects on volatility and prices are less clear, even though results based on panel data and estimation approaches that better identify transaction cost effects seem to find unexpectedly a *positive* relationship between transaction costs and volatility.

As argued above, a general transaction tax is advocated not only as a means for correcting market failure, but also as an efficient way to raise revenue. Schulmeister, Schratzenstaller, and Picek (2008) estimate that in Europe revenues from an FTT at a rate of 0.01 per cent would lie between 0.59 per cent and 0.78 per cent of GDP, an amount roughly similar to the estimated loss in revenue that is due to the exemption of financial services from VAT.²⁷ However, as noted by Matheson (2010), the argument that an FTT would cause little distortion because it would be levied at a very low rate on a very broad base is not persuasive once account is taken of the potential incidence of the tax. A tax levied on transactions at one stage ‘cascades’ into prices at all further stages of production.

The international experience also shows that tax design is crucial both for the effect of the tax on the functioning of the market and for revenues (Chapter 5 and Matheson 2010).

Finally, as noted in Chapter 11, the setting of transaction taxes is affected by the nature of the political process, which can lead to outcomes that are far from the optimal level of tax rates.

²⁷ They estimate a revenue loss from financial services VAT exemption of about 0.7% of GDP, assuming a share of the financial sector in overall value added of 3.5% and an average VAT rate of 20%.

1.3.4 *Redesigning the taxation of financial institutions*

The financial crisis has highlighted the distinctive features of the financial sector raising the issue of whether financial institutions deserve a special tax treatment because of the peculiar nature of their activities or whether their taxation should be subsumed under general principles applying to income and consumption taxation. Possible reforms can be grouped into two distinct sets: (1) piecemeal revisions of existing taxes or (2) more radical reform of the taxation of the financial sector.

1.3.4.1 FINANCIAL AND TAX ACCOUNTING

Despite the fact that banks are generally subjected to the same general tax provisions as non-financial companies, existing tax rules acknowledge the specific nature of their activities by allowing several differential tax treatments and exceptions to the rules that apply generally to business income. Banks are unique in that interest income and expenses represent the core of cash flows, depreciation allowances for fixed assets are relatively minimal, and the valuation of complex financial transactions (such as activities in the foreign exchange markets, trading in securities, and operations in derivative products) is recurrent. High degrees of leverage also typically characterize banking activity. The valuation of assets and liabilities is also subject to different criteria depending on whether the assets and liabilities are held in trading or investment portfolios. Trading portfolios are typically marked to market, but also investment portfolios are being increasingly subject to 'fair-value' rules.

The conformity of financial accounting and tax accounting (book-tax conformity) is of great importance for banks. Financial accounting standards and tax laws frequently provide specific, and often different, rules for how to report income for book and tax purposes, even though both income reports are based on the same underlying fundamental transactions.

1.3.4.2 MARKING TO MARKET

The taxation of gains (or losses) only when realized, rather than as they accrue, can create significant distortions, creating an incentive to defer the realization of gains and accelerate that of losses. Not surprisingly, marking gains and losses to market and treating them as current have gained in acceptance as a general policy principle. The principle also means that financial institutions are neutral in respect of transactions that involve simultaneous gains and losses such as wash sales.

There are some potential pitfalls in marking to market. Taxation on fair market value may induce the sale of assets to finance the accruing liability, though there is little sign that this has been a significant problem in the financial sector. Schizer (2000) has argued that the extent to which marking

to market has been used for tax purposes may have led dealers to become 'accommodation parties' for other taxpayers in transactions that artificially defer income for one party while accelerating losses for another. It has also been suggested that extensive use of marking to market in the taxation of financial institutions may increase the volatility of revenue.

1.3.4.3 PROVISIONING FOR LOAN LOSSES

The crisis has also drawn attention to difficulties in the tax treatment of loan losses (Chapters 6 and 8). Losses are an inevitable cost that banks incur in providing credit and are recognized as an expense for financial, regulatory, and tax purposes. The principal issues surrounding the treatment of loan losses concern the timing and manner in which expenses are recognized. These may differ depending on the different objectives pursued by auditors, regulators, and the tax authorities.

Three constraints affect the level of provisioning and the amount of write-offs that a bank may decide to make. First, company law lays down what banks are required to disclose in their balance sheets and profit and loss accounts. Secondly, supervisors are concerned to see that banks follow a prudent and responsible approach to making provisions. In the past, general reserves, which have not been earmarked, have been included in bank capital, whereas specific provisions have been excluded from such calculations. Finally, the tax authorities set out specific guidelines as to what they regard as allowable deductions against profits. One of the problems in understanding provisioning and its possible effects is that each of these various types of valuation may differ markedly within a single country.

For financial and regulatory accounting purposes, banks may set aside either specific or general provisions to reflect the possible deterioration in the value of their assets. In the first instance it falls to the banks to decide what they consider to be the correct value of their assets and, consequently, to choose the appropriate level of provisioning that should be made. Specific provisions (or reserves) are made against clearly identifiable problems, which can be expected to occur in connection with the affairs of a particular customer or group of customers. General provisions permit a blanket cover against all possible expected future as well as current losses. For financial accounting purposes (IAS 2002), general provisions relating to losses that are present in existing portfolios of loans but have not been identified specifically are treated as an expense. However, provisions relating to future losses are accounted as appropriations of reserves.

Provisioning is materially assisted by the possibility of an offset against tax for the annual charge that is made in the profit and loss account. Decisions on tax deductions are made by the fiscal authorities and need not be consistent with regulatory and supervisory requirements.

Tax accounting practices do not generally conform to financial accounting practices and prudential regulation. The broad objective of both tax and financial accounting is measuring income. However, the objective of financial and especially prudential accounting is conservatism—that is, to delay income and anticipate expenses. Tax accounting is designed to ensure that income is not understated. Nonconformity gives rise to timing differences.

The tax treatment varies widely across countries. There are broadly two approaches. The so-called *charge-off method* recognizes a tax deduction only when loans become worthless. Countries that follow this approach are the United States, Australia, Korea, Malaysia, and the Philippines. The tax authorities in most other countries for which information is available tend to allow *specific provisions* but differ widely in terms of the degree of conformity with financial and accounting for loan losses, the required evidence regarding the deterioration in asset values, and in some instances the maximum amount of loan losses allowed in a single year. The most favourable countries from this standpoint appear to be France, Germany, and the Netherlands. Finally a few countries (for example, Germany and Singapore) also allow general provisions (as a percentage of qualifying loans), but these are subject to limitations.

Provisioning rules can have several effects on the international activities of banks of different nationalities and the allocation of banks' assets across financial centres. First, banks may decide to allocate their loans in centres where provisioning is most generous. Second, generous provisioning policy can be an implicit subsidy to banking relative to other forms of financial intermediation and can affect interest rates charged on differing forms of financing. Generous provisioning may allow certain financial institutions to shield a sizeable part of their income from tax and thereby obtain a competitive advantage. Third, where accounting and fiscal definitions of income do not broadly coincide, banks may be unwilling to set aside an appropriate level of provisions unless the tax authorities permit tax deductibility. Finally, different tax-provisioning policies can affect the character of risk taking by banks and the distribution of their profits over time. The treatment of claims on problem debtor countries was one area where differing tax provisioning rules led banks to adopt diverse behaviour.²⁸ In those countries where tax provisioning for such claims was limited, there was an incentive for banks to realize losses outright, through

²⁸ One of the clearest examples of the subtle tax distinctions between various nationality groups of banks occurred at the time of the Mexican financing package (1990) put together under the Brady debt relief initiative. Under that scheme banks agreed to convert their rescheduled credits (amounting to about 85% of Mexico's external debt) into bonds at a reduced face value (65%) and market interest rates (LIBOR + 13/16), into bonds having the same face value but a reduced and fixed interest rate (6.25%), or to provide new loans equal to 25% of banks' exposure. A survey of the major banks involved indicated that tax considerations together with regulatory and business strategies with Mexico were the major factor determining the decision of which instrument to choose (Hay and Paul 1991).

sales of their loans in secondary markets or by establishing losses through specially authorized loan sales.²⁹ By contrast, the possibility of tax deductions for provisions encouraged banks in some countries to allocate large amounts of their capital to less-developed countries (LDCs), possibly inhibiting the disposal of their assets on the secondary market for country loans.³⁰

Though there are important overlaps, the objectives of tax policy need to be recognized as distinct from those of regulatory and accounting practices if all are to be well aligned with one another. Tax policy towards financial decisions is appropriately charged with raising revenue without creating excessive distortions. Any remaining non-tax distortions to financial decisions are then best left to regulatory policy. Clearly there are monitoring and compliance advantages in applying common definitions and concepts for tax and accounting purposes, and there has been substantive discussion of possible corporate governance advantages in closely aligning tax and book profits. But the ideal tax base is not necessarily the most accurate measure of current income. There are, for instance, and as will be seen, potential advantages in allowing full expensing of investment for tax purpose. And even where, or if, marking to market were felt to be inappropriate for financial accounting purposes, a strong tax rationale for doing so—as much to avoid distortions as it is to fine-tune the measurement of income or wealth—would remain.

Issues concerning the tax treatment of provisions for bad loans would be raised by moving towards dynamic provisioning. Dynamic provisioning would include a systematic and mandatory counter-cyclical element of general provisioning, raising questions as to their tax treatment. To the extent that dynamic provisioning would be analogous to depreciation allowances for physical assets that reflect their expected reduction in value (or sometimes more, if accelerated depreciation is allowed), deductibility could be argued to be appropriate. Other approaches would be appropriate if the CIT were to be fundamentally reformed.

1.3.5 *Other issues*

1.3.5.1 REVISITING HARD-TO-TAX AREAS

More recent discussions appear to have taken the direction of suggesting that financial institutions and market should be subjected to special tax treatment.

²⁹ In the United States the value of a tax deduction depends in part on whether it is applied against domestic or foreign source income. Since many banks have only limited potential liabilities in respect of foreign source income by virtue of the tax credits from double taxation relief, tax deductions against foreign source income reduce the value of these tax credits.

³⁰ In Japan, where tax deductibility for provisions against loans to problem debtor countries has until recently been limited, losses realized on loan sales in the secondary market have generally not been recognized. However, in some instances these restrictions have been waived and Japanese banks have been able to sell existing loans to a factoring company set up jointly by the major banks.

While many of the proposals overlap with the topics already covered in the previous sections, mention should also be made of proposals to change the VAT status of financial institutions. These proposals that have been suggested only informally³¹ may be seen as an alternative to corrective taxes, as a manner to reduce the excessive size of the sector as well as a means to raise revenues in a relatively efficient way by reaping the rents of the sector.

1.3.5.2 THE TREATMENT OF TAX HAVENS

Tax havens have been the object of intense scrutiny in the 2000s. The focus has been on both the lax tax regimes of these jurisdictions as well as the often weak regulatory framework particularly in respect of hedge funds and various types of SPVs. Often, the centres are said to facilitate criminal activities, since some centres do not comply with the Financial Action Task Force (FATF) rules in respect of anti-money laundering regulations.

The crisis has coincided with a step-up in a generalized clampdown on undeclared offshore accounts, which had been building up over the previous decade. A number of very publicized episodes have involved the transfer to the tax authorities of the names of holders of offshore accounts. Individual financial institutions have been held responsible for encouraging unlawful activity and faced significant fines. The authorities appear to have exploited the wave of anti-bank feeling to extend their extra-territorial powers and step up international cooperation to push through further anti-evasion measures.

A different set of issues is raised by the exploitation of regulatory and tax arbitrage involving offshore centres. The use of offshore centres to create corporate or other types of vehicle is often driven by the absence of adequate onshore forms of intermediation, particularly for foreign investors. This may be due to delays in creating enabling legislation and uncertainty in respect of the nature of domestic legislation.

1.4 The tax policy and the macroeconomy

During the crisis the governments implemented several measures to avoid the collapse of the financial system and to alleviate the economic consequences of the crisis on the real economy. The direct effect of these policy measures has been a sharp deterioration of public budgets. In the EU the average public-sector deficits increased from 0.9 per cent of GDP in 2007 to 6.8 per cent in 2010 and over the same period the public sector debt jumped from below 60 to above 80 per cent of GDP (Chapter 5).

³¹ This suggestion appears implicitly in IMF (2009a).

Government debt management and fiscal consolidation will certainly remain crucial issues in the public policy debate for several years. In Chapter 9 McCauley and Ueda notice that government debt management is often discussed with reference to the question of whether central banks should proceed to extraordinary buying of government bonds. There are other relevant issues, such as how treasury debt management can contribute to maintaining the growth of bank assets, lowering the long-term bond yields or reducing net government interest payments, which are rarely analysed, despite the relevance they have in the post-crisis scenario. Based on the experience of the United States in the 1930s and Japan in the 2000s, McCauley and Ueda suggest that governments may indeed benefit from issuing long-term debt with interest rates tied to short-term bill rates in the confidence that monetary policy will keep yields low. As long as short-term rates remain low, treasuries will benefit from interest cost savings. When the economic activity quickens and interest rates rise again, they will benefit from higher taxes in compensation for higher servicing costs.

Chapter 10 addresses the crucial question of whether fiscal consolidation may have a contractionary or expansionary effect. According to the conventional 'Keynesian' approach, a public deficit reduction, achieved either through a cut in government expenditure or through an increase in taxes, brings about a decline in aggregate demand and depresses the rate of growth of GDP. Fiscal consolidation may curb the recovery with the risk of pushing the economy back into recession. In recent years the Keynesian view has been challenged by several papers on both theoretical and empirical grounds. Bilicka et al. in Chapter 10 present a survey of the theoretical literature and a critical evaluation of the empirical evidence. They identify several factors that seem to increase the probability of a fiscal consolidation being expansionary and use them to attempt an evaluation of the possible impact of UK fiscal consolidation announced in 2010. However, the authors highlight a number of weakness in the empirical literature, which include the lack of very clear identification of both fiscal consolidations episodes and expansionary effects.

1.5 Conclusions

While there is little conclusive evidence that the tax system played a major role in triggering the tax crisis, there is growing support for making taxes play a prominent role in policy responses. A number of special taxes have been introduced and proposed to recover the cost of the 'bailout'. These have involved both special taxes on financial institutions as well as taxes on bonuses. The revenues of these special taxes have been quite significant, but the ultimate

incidence of these measures remains uncertain. It is also unclear whether these measures will continue in the future.

The ongoing debate has also highlighted that taxation may be used as a corrective instrument to complement prudential regulation of the banking sector. Some corrective tax proposals aim to curtail activity in the financial sector ('Tobin taxes'), on the grounds that a large number of transactions are either speculative or of no social use. No international consensus has emerged to date as to the most appropriate approach. Without some of global coordination, such measures would inevitably create competitive distortions across countries and market segments, as suggested by numerous past experiences.

The crisis has also drawn attention to a number of well-known weaknesses in the taxation of the banking sector, particularly in respect of loan loss provisioning, the relationship between financial and tax accounting, mark-to-market accounting, and value-added taxation. These issues are by no means new. The crisis has added saliency to finding longer-term solutions. Unfortunately, after renewed attention to these questions, the political climate no longer appears propitious to address the needed structural reforms.

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