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Article Review: Taxation and the Financial Sector

Shakelford, Shaviro and Slemrod discuss the causes of the latest economic disaster. They discuss that the cause of the latest disaster was a credit boom and housing bubble. They said that a number of financial firms placed bets against a decline in the housing market (2010, pp. 783). Their bets against the housing market were so large that when the housing market failed it led to the organizations becoming insolvent. This had effects on the economies throughout the world. The question proposed in this article review is if income tax systems helped cause the failure of the financial markets.

Shakelford, Shaviro and Slemford identify some of the culprits that caused the financial disaster. The are,

> (1) mortgage originators who had no stake in the borrowers' ability to pay, (2) borrowers who accepted easy credit, such as through back-loaded subprime mortgages that financed home purchases that they could not afford, (3) opaquely structured securitization that neither sellers, buyers, nor rating agencies fully understood, (4) the rating agencies' eagerness to make money by offering AAA ratings to risky issuances by paying clients, (5) the existence of "heads we win, tails you lose" incentive structures for financial firms and their managers, (6) capital-adequacy regulations that were riddled with loopholes that financial firms increasingly learned to exploit, (7) financial institutions' use of derivative financial instruments to ramp up and concentrate, rather than offload and diversify, their downside risk exposure, and (8) failed risk management models that underweighted the possibility and impact of a national decline in U.S. real estate prices.

There are, however, contributions that the tax system made to this problem. The authors exemplify this by stating that in certain countries, income tax rules may have encouraged both excessive corporate leverage and highly leveraged home ownership. Income taxes could have contributed to governance problems in publically traded companies as well as proliferation of non-transparent financial instruments that played a key role in the crisis (2010, pp. 783).   These problems have existed prior to the financial meltdown so one can deduce that these problems were not the direct cause of the meltdown but may have been fuel for the fire.

The authors discuss some solutions to the financial meltdown that involve tax strategies. The first is Pigouvian taxation of the financial sector. This is a tax that can be put on all businesses equally and it will solve the problem uniformly. For example, the author illuminates this by discussing that if the insurance protection that the government provided was so certain, comprehensive, and instantaneous that it would eliminate associated harms such as lost liquidity from bank runs that spreads outward via contagion, a correctly priced insurance fee might become close to being a full Pigouvian tax (2010, pp. 793). The authors go on to discuss that this method has it's problems such as, continuing with the previous example, contagion from one institution's actions would affect the expected cost of the government to provide insurance coverage to other firms. Also, gaps, delays and uncertainties in the insurance coverage would mean that the system fell short of remedying the problems caused by the risky investments (2010, pp. 793).   A conclusion reached by the authors is that regulatory command is going to be necessary because Pigouvian taxation cannot completely solve this problem. There are several alternative tax proposals.

The financial transactions tax (FTT) is based on the amount of which financial assets are sold. This idea predates the financial meltdown and has been around for a while and does not include a world where financial derivatives exist. Research has shown that this method of increased transaction costs does not help the market. Instead, Shakelford, Shaviro and Slemrod highlight problems such as,

> (1) raising the costs of capital for entities issuing new securities, (2) through its downward effect on trading volume, reducing liquidity and price discovery, while also potentially increasing short-term price volatility, and (3) displacing securities trades from taxed to untaxed venues (2010, pp. 796).

The authors also discuss a bonus tax. This tax has been enacted in Britain and France and according to the authors at the time of this article a amendment was offered to the US financial reform bill that would impose a one time, 50% tax on bonuses of more than $400,000 paid to executives of Fannie Mae, Freddie Mac, and other financial institutions that received at least 5 billion from TARP (2010, pp. 797). This method directly taxes those executives that are responsible for causing the meltdown and profited from it. This is considered a blunt instrument by the authors for assessing a tax on those who are culpable for the financial problems. The last area to be explored as an alternative tax proposal is levies on financial institutions. The purpose of this fee was to collect $90 billion from 2011 – 2020, which would go into general revenues to offset the cost of the 2008 bailout fund. This tax affects 60 firms in the US as a result of it applying to firms whose assets exceed $50 billion. Germany and France have announced their own plans to place levies on banks and Germany and Britain announced they would draft a plan for G20 countries.

Shakelford, Shaviro and Slemrod provide these thoughts as to the reasons for the enactment of the measures discussed in this review. They are,

> (1) a desire for retribution or recompense from parties deemed to have caused, and/or profited from, the recent crisis, (2) a desire to align private incentives with the social cost of activities that demonstrably have potentially catastrophic external contagion effects, so as to reduce the likelihood of future crises, and (3) a desire to raise revenue to offset the government fiscal imbalances exacerbated by the cost of dealing with the financial crisis and subsequent recession (2010, pp. 800).

The authors also go on to remind us that the burden of the taxes may not fall on those it is actually intended for, since the burdens do not fall on legal entities, such as companies, but on people. Pigouvian taxation may be useful to a certain extent but needs regulation to work with it. FTTs are not seen as the solution because they can be avoided via sophisticated derivatives. Bonus taxes can help tax those responsible for the meltdown that profited from it.   Levies on financial institutions that can be classified as institutions culpable or potentially culpable help generate revenue to offset the massive debt caused by the financial meltdown.

References

Shakelford D., Shaviro D., Slemrod J. (2010). Taxation and the Financial Sector. *National Tax Journal, 63*(4, part 1), 781-806. Retreived from ABI/Inform complete