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The Problems With The Bank Tax

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Last week the Obama administration announced a plan to impose significant new taxes on banks. It was high political drama. The stern-faced president was flanked by his scowling Treasury Secretary, Tim Geithner, and his dour chief economic adviser, Larry Summers. The whole tone of the announcement was that of a trip to the woodshed for misbehaving banks. The tax was presented as a punitive reaction to the revived profitability of the banks, something the administration had aggressively sought to bring about.

The problem here is not the taxes per se. It is that the administration elected to treat the imposition as populist political theater. In doing so it missed the opportunity to articulate a well-reasoned economic policy to deal with too-big-to-fail institutions. And in the process it got completely wrong-footed with the regulatory reforms the House and Senate are currently considering.

Another problem with treating the tax as punitive rather than regulatory is that it gives the banks and other financial institutions the ammunition to fight it. This administration tends to treat too many of the economic problems it faces as political. They end up being far less effective.

There is a very sound argument for levying new fees on financial institutions. The financial system as it is currently structured is extremely distorted, and its distortions are due to the way the system was regulated and by the regulators' responses to the financial crisis. Basically over time we have encouraged, through regulation or the lack thereof, the creation of large, complex, interconnected financial firms. In response to the financial crisis our regulators decided that many of these firms were too big to fail. In trying to rescue them we made them larger, more complex, more interconnected and arguably riskier.

It is now clear to almost everyone except the institutions themselves that we created a big problem. Firms that are deemed too big or too systemic to fail have a safety net. They can take bigger risks and make bigger bets, secure in the belief that the government (or taxpayers) will guarantee their liabilities if they fail. Not only does this create perverse incentives for the risks that they take, it lowers their cost of raising new capital.

In the heat of the financial crisis Henry Paulson, Tim Geithner, Ben Bernanke and others decided it was better to protect all of the troubled firms (except Lehman and Washington Mutual) rather than let them fail. Rumor was that they would have arranged a deal for WaMu had the FDIC not closed them first. In almost every case they bailed out bondholders at the expense of taxpayers.

That was then. Now we must figure out how to undo the damage. In a more perfect world we would do three things: 1. modify the bankruptcy code and create mechanisms to allow for the orderly failure of these institutions; 2. impose a tax on them that is proportional to the risk to the system that they create; and 3. treat that tax as an insurance premium to cover the cost of future problems, just as the FDIC charges banks for deposit insurance.

Greg Mankiw, in his excellent blog, argues that the bank tax does a pretty good job at No. 2. In the administration's proposal the tax would be levied on a firm's liabilities. For purpose of this tax they are defined as Assets less Tier1 Capital less FDIC Insured Deposits. It would apply to firms with more than $50 billion of assets. The idea is that the tax would induce these firms to decrease their leverage by holding more Tier1 Capital. It also has the effect of favoring deposit-taking institutions since FDIC insurance currently is capped once the fund reaches a certain size. That presumably has to change given our recent history.

An important flaw in the tax is that it is designed only to recover the bailout costs already incurred. It should be an ongoing charge for the insurance against risky behavior. There should be two parts to such a charge: A portion to cover the risk a firm creates for itself and its investors by taking on excessive leverage, and a portion to cover the risk that leverage creates for the system as a whole. Ideally what we want is a fund that can cover the costs of a shock to the system in the future without the involvement of taxpayers.

It is curious that this proposal has been put on the table at this time. The regulatory reform proposals working their way through the House and the Senate both have many elements designed to address the too-big-to-fail problem, including proposals for fees on systemic institutions. In the hearings before the House banking committee Secretary Geithner was at odds with Sheila Bair of the FDIC and many others over whether it made sense to charge fees ex-ante or ex-post. He favored the latter, and he seemed to have lost that argument on logical grounds. It may be that this is his attempt to preempt the issue.

At the end of the day what we need are mechanisms to deter excessive risk-taking at the expense of the taxpayer. The proposed tax is a very imperfect step in that direction. But we should hope that at the end of the process of designing a new regulatory structure we will have a set of measures that protect the taxpayer from having to bail out the financial system in future crises. One lesson that history teaches us very clearly is that crises will occur.

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