Insight

Taxing Banks, No Thanks

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With news that financial reform legislation is headed for the Senate floor, it is time to officially scrap the administration's proposed Financial Crisis Responsibility Fee—the "bank tax." Now, before the populists with pitchforks and torches start after me, let me emphasize that, sensibly, the TARP law says that the taxpayers must be given a path to recouping their losses.

In effect, the TARP empowered the federal government to spread institution-specific over taxpayers and into the future, thereby relieving immediate stress on select financial market participants. This is a valuable service for which payment is sensibly due.

But when should recoupment take place? The law says that in 2013—five years after enactment—the president must make a proposal. So, there is no statutory reason to implement a bank tax now.

Moreover, doing it now is likely to make things worse, not better, for small and medium-sized borrowers. The White House may hope and believe that tax will be subtracted from employee compensation, but competitive pressures will likely dictate against labor bearing the burden. Instead, it will either come out of bank capital or be passed along as higher borrowing costs. The former will limit the supply of loans and the latter raise their costs.

This is not what a struggling real economy needs at this time. While modest growth in final sales has emerged, employers show no appetite to hire. It is widely agreed that this is the wrong time to raise taxes. It is even less desirable to levy one that constricts the flow of credit to the business sector.

More generally, it makes sense to wait because it is not obvious how much the taxpayers will need to recoup. In its short life the estimates of losses under the TARP have shifted dramatically. On Sept. 28, 2008, the day the legislation creating TARP was released by the House Financial Services Committee, the Congressional Budget Office (CBO) concluded in a seven-page letter to congressional leaders that "enacting the bill would likely entail some net budget cost—which would, however, be substantially smaller than $700 billion."

Since then CBO, the Office of Management and Budget (OMB) and Treasury's Office of Financial Stability (OFS) have ventured roughly eight guesses as to what the net present value of the lifetime costs for TARP will be. Those estimates include $189 billion in January 2009 by CBO, $247 billion in February 2009 by OMB, $356 billion in March 2009 by CBO, $341 billion in August 2009 by OMB, roughly $141 billion in December 2009 by OFS, $117 billion on January 13, 2010, by an unnamed White House official, $99 billion on Jan. 26, 2010, by the CBO and the final estimate of $109 billion by the CBO.

Going forward, as housing markets adjust to the post-bubble environment, the underlying economic calculations change as well. This raises the concern that the downstream effects also remain uncertain. How much will ultimately end up on the public books? One simply cannot know without allowing more time to pass. Indeed, the only evident reason to rush the issue is to score political points before the mid-term election.

At the right point in the future, then, it would be appropriate to revisit recoupment of TARP costs. In doing so, however, good policy dictates that any proposal distinguish between recouping the money and forward-looking objectives of financial regulation policy.

The former goal is simply about getting the cash back from those who lost it, notably AIG, GM, GMAC, and Chrysler. A tax structured in this way bears little resemblance to the current proposal; indeed it is not a "bank" tax at all.

Faced with this criticism, proponents often pivot to financial reform goals, including incentives for reduced leverage. Excessive leverage—in households, banks, the federal government, and elsewhere—is a signature of this era in U.S. economic history. One can understand, then, the appeal of using a bank tax to penalize leverage, especially excessive leverage. However, there are a multitude of related policies under consideration in Congress—larger capital requirements for systemically-important institutions, payments into a wind-down fund to cover future costs, "living wills" to expedite the winding down of failed large banks, and so forth—that also affect leverage.

Regardless of their individual merits, it is clear that the proposed bank tax interacts to affect the desirability and effectiveness of each of these other proposals. Thus, it never made sense as a freestanding initiative, but should have been structured as part of the broad regulatory reform initiative. With news that the latter may be moving forward, it is time to drop the bank tax entirely.

The TARP is one of the most controversial policies in recent memory. Financial regulation reform is one of the most important initiatives the country faces. Any bank tax should be designed to meet the genuine goals of the former or further the objectives of the latter. The administration's tax does neither, and gets in the way of recovery in the process.

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