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Taxation of financial activities

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# Taxation of financial activities

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**Abstract:** A range of tax proposals which are selective taxes in the sense of being largely or wholly applied to the financial sector and not to other sectors, and hence which are not taxes such as income tax, profits tax which are applied across the board are examined. In this paper three sets of proposals are examined, namely financial activities tax, 'excessive profits tax' and bank bonus/variable pay taxation (financial transactions taxes have been examined in other paper).

**Key words:** taxation, financial activities tax,

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## Introduction

This paper examines a range of tax proposals which are selective taxes in the sense of being largely or wholly applied to the financial sector and not to other sectors, and hence which are not taxes such as income tax, profits tax which are applied across the board. The most discussed proposals in this area relate to financial transaction taxes and they have been considered fully in two related papers, Boffo (2014), Arestis and Sawyer (2014). In this paper three other sets of proposals are examined, namely financial activities tax, 'excessive profits tax' and bank bonus/variable pay taxation.

In considering taxes which are specific to a particular sector of the economy, in this case the financial sector, there could be three broad motivations (in addition to that of raising revenue<sup>1</sup>). The first would be influencing the behaviour and size of the sector concerned on the basis that certain activities in that sector should be discouraged and more generally that the sector has become 'too large' and is imposing negative externalities on others. The financial transactions tax may be viewed as a partial example of this in that it can be seen as putting 'sand into the wheels' (to use Tobin's phrase) and to reduce the volume of transactions in currencies, on the stock market or in derivatives and securities (depending on the structure of the tax).

The second is that activities and behaviour which are undertaken in most or all sectors of the economy may particularly adverse effects in the financial sector and as such steps are advocated to address those forms of behaviour in the financial sector. A key example here would be the use of incentive, variable pay (including bonuses) which are widely used and which have a range of positive and negative effects on behaviour and performance. In the financial sector, and particularly in the aftermath of the financial crisis of 2007/09, variable pay was viewed as problematic and a contributing factor to the generation of the crisis<sup>2</sup>. Variable pay was seen as encouraging excessive risk taking where the effects of such risk taking were interconnected and adverse.

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<sup>1</sup> In that regard, it can be noted that there is often suggestions for linking the revenue from such financial activities taxes with specific, if unrelated, expenditures. A notable example is for the proceeds of a financial transactions tax to be used for development and environmental purposes.

<sup>2</sup> For FESSUD work on this see Lagoa, Leão, and Barradas (2014), Gabbi, Kalbaska, and Vercelli (2014).



Sales related incentives feeds into mis-selling: a particular example being the incentives given to individuals to approve loan applications where their pay is linked with sale of loans. The rationale for banker (or others) bonus tax is to discourage the degree of variable pay, and as discussed below from the perception that risk taking is encouraged by variable pay (with profits rewarded but not losses). A financial transactions tax could also be placed under this heading in so far as the belief is that the taxation of financial transactions would reduce short-term trading and volatility of prices (the discussion of that proposition is in Arestis and Sawyer, 2014).

The third motivation relates to particular aspects of the distribution of income between the financial sector and the non-financial sector and within the financial sector. The effects of taxation on the distribution and re-distribution of income are, of course, more general ones related to the progressivity of the over-all tax system, the relative taxation of different forms of income. With regard to a specific sector such as the financial sector, taxes can be levied (usually ex post) on what are deemed to 'excessive profits' and/or windfall gains which are in some sense regarded as unfair. The financial crisis of 2007/09 and the associated 'great recession' imposed heavy costs in terms of unemployment and lost output, and the fiscal costs of bank bail-outs and rescues. Many explanations of the generation of and triggers for the financial crisis were put forward, and in Work Package 3 these explanations have been critically evaluated<sup>3</sup>. There were explanations which focused on a range of risk-taking behaviour in the financial sector which had been in some sense excessive, and which in effect increased the probability of a financial crash. There was underestimates of the correlations between the risks being taken. The costs of this excessive risk taking through the financial crisis, unemployment and bail-out were seen to largely fall on the rest of the economy and not on the financial sector.

In the aftermath of the financial crisis, two ideas came to the fore with respect to taxation and regulation of the financial sector. The first was to ascribe the financial

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<sup>3</sup> For the overview of the FESSUD studies see Evans (2014); the detailed studies on each of eight explanations which have been advanced are available on the FESSUD web-site



crisis and the banking collapses (and hence costs of bail-outs) to a significant degree with risk-taking behaviour and particularly that the risks which were taken were underestimated particularly as individual risk-taking fed into systemic risks. This could be deemed to have combined to increase the probability of financial crisis.

Foo (2008) in writing on the causes of the financial crisis notes the role of 'excessive lending' which 'was fed by the behaviour of younger professionals (who tend to underestimated the risk of default), the existence of compensation schemes that related bankers' bonuses to short term profits of banks, and the strong competition between banks that lead to riskier lending in order to gain market share and increase profits (this opinion is shared by Nelson and Katzenstein, 2011; and Ashby, 2010)' (WP 37). 'Remuneration schemes favoured high risk/high return investments (Acharya and Richardson, 2009; Crotty, 2009; Kashyap, 2010). Lang and Jagtiani (2010) focus on the fact that managers were given incentives to increase the profitability of their business lines rather than consider the corporation's overall risk position' (WP37)

The second was that the financial sector should be taxed as some form of compensation to the government and the public for the costs of the financial crisis and bail-outs and/or some contingency funds to cover the costs of future crises. These thoughts led to the argument that the 'taxation of the financial sector can be seen in two ways. First, when applied to risky behaviour, taxes can be a corrective tool that *reduces the probability of future crises*. And second, financial sector taxes can also provide a means of adding to government coffers the resources necessary to *cover costs of past and any future crises*.' (Gottlieb, Impavido, and Ivanova (2012, emphasis in original)

We can examine two propositions. The first is in what ways taxes can be designed of specific relevance to the financial sector which would address this 'excessive risk taking'. And further how would such taxes compare with alternative policy instruments, and notably regulation. 'Taxation could supplement regulation of financial institutions because it can be focused on risks to the overall financial system rather than just on individual financial institutions (Keen, 2011). While regulations like



minimum capital requirements create buffers that help individual institutions absorb losses, taxation can provide the resources governments need to intervene systemwide. Furthermore, over time, taxation allows for more efficient distribution of losses—by collecting from the current generation to pay for the losses its actions might impose on future generations.’ (Gottlieb, Impavido, and Ivanova, 2012).

Keen (2011) notes that ‘there are broadly two main ways in which one can address any externality: by regulating aspects of behaviour directly, or by using tax measures to influence that behaviour indirectly. ... In relation to financial activities, regulation has long been dominant, in the form, in particular, of minimum capital requirements for banks. Taxation—except in the shape of deposit insurance, justified primarily as a defense against bank runs—has played no significant role. But it could. An alternative (or supplement) to regulatory capital requirements, for instance, would be to use tax measures—such as taxing banks’ wholesale borrowing—to discourage low capitalization. ... [T]he regulatory approach has had an unquestioned dominance in relation to financial sector that is in stark contrast to the standard prescription for tax-type measures as the best way to dealing with many other externalities, such as those associated with climate change.’ (Keen, 2011).

‘Second, taxes ... may have role in supplementing regulation *in addressing adverse externalities* from financial sector decisions, notably through the creation of systemic risks and excessive risk taking.’ (IMF, 2010). However, ‘**taxes and regulation face complex complementarities and potential trade-offs, however, which are still poorly understood**’ (bold in original)

The second is illustrated by the request of G-20 leaders to the IMF ‘to prepare a report ... 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’

‘Expecting taxpayers to support the sector during bad times while allowing owners, managers, and/or creditors of financial institutions to enjoy the full gains of good



times misallocations resources and undermines long-term growth. The unfairness is not objectionable, but may also jeopardize the political ability to provide needed government support to the financial sector in the future.... Sole reliance on 'ex post' recovery, however, [is] ... argued to have substantial drawbacks of both incentives and fairness' (IMF, 2010).

'Measures related to levies and taxes should: ensure that the financial sector meets the direct fiscal cost of any future support; make failure less likely and less damaging, most importantly by facilitating an effective resolution scheme; be reasonably easy to implement, including in the degree of international coordination required; enable, to the extent desired, an additional fiscal contribution from the financial sector to recognize that the costs to countries of crises exceed the fiscal cost of direct support; and address existing tax distortions at odds with financial stability concerns. A package of measures may be needed to attain these objectives.' (IMF, 2010)

'In the run-up and in the wake of 2007 financial crisis, the question of additional taxes on the financial sector taxation has been debated in academic and policy circles " *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*" (IMF, 2010).

### **Financial activity taxes**

The underlying rationale for financial activity taxes (FAT) can be viewed in terms of the relative undertaxation of the financial sector in that indirect taxes such as value added tax are often not applied to the financial sector. There are, of course, examples of where forms of indirect taxation (other than financial transactions tax) are applied to parts of the financial sector. This can be complemented by the use of FAT to seek to reduce the size of the financial sector. The argument can be put that levying taxes on a sector will have effects on the demands for the goods and services of that sector. The tendency to undertax the financial sector would imply that other sectors are relatively overtaxed and those sectors perhaps relatively smaller than they would have been, and the financial sector relatively larger.



'a FAT would effectively be a tax on value added and so would partially *offset the risk of the financial sector becoming unduly large because of its favorable treatment under existing VATs*. For technical reasons, financial services are commonly VAT-exempt—which means that, purely for tax reasons, the financial sector may be under-taxed and hence perhaps 'too big'. ... Taxing value-added in the financial sector directly would mitigate this.' (emphasis in original, IMF, 2010)

'The EU's common value added tax system has generally exempted mainstream financial services including insurances and investment funds. Article 135(1) of the VAT Directive provides an exemption from VAT for most financial and insurance services.' There is an option for member States to tax financial services. 'The difficulty is, however, to technically define the price for specific financial operations. Around two-thirds of all financial services are margin based which makes the implementation of the invoice-credit VAT system very difficult in this respect. In practice however this difficulty seems to be insurmountable—for instance in Germany when the granting of loans is subject to VAT under the option to tax, an acceptable methodology seems to have been found to tax these margin-based operations.' (EC, 2011a), Insurance premia can also be subject to being taxed (as in the UK). EC (2011a) present estimates of the potential tax advantage of the VAT exemption of the financial sector and put it at the order of 0.15 per cent to 0.20 per cent of GDP. 'In summary, the VAT exemption for a large share of financial services is an important issue. It possibly results in a preferential treatment of the financial sector compared with other sectors of the economy as well as in distortions of prices' (EC, 2011a). Buettner and Erbe (2014) find that a 4% FAT in Germany would generate similar revenues and welfare effects as the repeal of VAT exemption (at a rate of 19%) for the financial sector.

A FAT is essentially a tax on the sum of profits and remunerations of the financial sector, and as such has features of being close to a variant for a value added tax on the sector since sum of profits and remunerations is a good proxy for value-added. Cannas et alia (2014) then note that a FAT 'present little distortions to the extent that it can be designed to mostly tax the rents of the sector'. The European Commission





(2011a) considered three variants of a FAT –(i) profits of financial institutions in cash-flow terms plus remuneration paid by the sector; (ii) as (i) with remuneration replaced by notion of 'excessive remuneration', (iii) sum of cash flow profits above a specified return on capital and 'excessive' remuneration.

'A FAT could also in theory reduce the size of financial institutions to the extent that the tax is passed through into higher prices for financial services and that the demand for these services is sufficiently elastic. The pass-through into high prices is more likely under the broader design of the FAT because for the same rate the tax would be higher but also because smaller designs of the FAT would increasingly target the economic rent and not the normal profit. A FAT would however normally have little effect on leverage' (Cannas et alia, 2014).

The proposals for financial activity taxes have received rather little attention in recent years, particularly relative to those for a financial transactions tax<sup>4</sup>. Those two types of tax are not mutually exclusive as the FTT relates to transactions in specific financial assets (depending on the proposals), whereas the FAT relates to the value added of financial institutions. They are both revenue raising and would tend to reduce the size of the financial sector.

A FAT would help remove the relative under-taxing of the financial sector through its general exemption from VAT (and the counterpart the relative over-taxing of the real sector). From that perspective, it can clearly be argued that there are distortions in the tax system which favour the financial sector over the non-financial sector, and this line of argument would also point to the financial sector being 'too large' (and the non-financial-sector 'too small').

There could be elements within a FAT, depending on its precise design, of an 'excessive profits' tax. The IMF argued that 'with inclusion of profits only above some high threshold rate of return, the FAT would become a tax on 'excess' returns in the financial sector. As such it would *mitigate excessive risk-taking* that can arise from

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<sup>4</sup> Iceland though has introduced such a tax, levied in 2014 at the rate of 5.5 per cent.



the undervaluation by private sector decision-makers of losses in bad outcomes (because they are expected to be borne by others), since it would reduce the after-tax returns.' (IMF, 2010). It is undoubtedly the case<sup>5</sup> that there has been, at least up until the financial crisis, a boom in the profits of the financial sector and a shift of profits from non-financial sector to financial sector. In that regard, though, it should be observed that what are deemed non-financial corporations often make a substantial portion of their profits from financial activities. The questions which would arise in this context are, first, whether the financial sector should be singled out in this manner for its 'excessive returns' to be taxed, and not the 'excessive returns' in other sectors. In a similar vein, it could be asked whether excessive risk-taking has particularly severe consequences in and for the financial sector. A further question would be how well targeted would the mitigation of excessive risk taking be, and whether this form of the FAT would be a valid instrument (particularly as compared with forms of regulation and codes of conduct for the determination of variable pay and bonuses).

### **Excessive profits taxes**

The levying of 'excessive profits' tax is generally undertaken retrospectively, and has, of course, to have some norm against which profits are deemed excessive (or similar phrase). The 'excessive profits' taxes considered here have a general feature of being levied on a specific industry or sector, and our focus will be on the financial sector. It is quite often the case that the revenue from 'excessive profits' taxes are earmarked for specific spending programmes.

Some origins of excess profits tax traced back to World War 1, and the accusations of 'profiteering'. However, most other experiences of excess profits tax have been focused on specific activities and events which are viewed as giving rise to excess profits. What are essentially excess profits tax have sometimes been described as a windfall tax which is suggestive of some specific events which have generated high profits and which are regarded as not resulting from the efforts of the sector/firms

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<sup>5</sup> See, for example, Brown, Passarella, Spencer (2015).



concerned. In the financial sector, an example was a UK windfall tax on banks in the 1981 budget levied on the grounds that at a time of high nominal interest rates banks were able to profit from the margin between their lending interest rates and zero interest rates paid on current accounts.

In his first Budget speech in June 2010 the UK Chancellor of the Exchequer Osborne announced that a new levy would be introduced from January 2011 to “apply to the balance sheets of UK banks and building societies, and to the UK operations of banks from abroad” which would “generate over £2 billion of annual revenues.” In subsequent budgets the rate of the levy has been changed, and see Seely (2014) for details. The UK Chancellor of the Exchequer (George Osborne) argued in favour of the proposed bank levy along two lines. ‘The first is to ensure there is a price ... paid for the implicit insurance that we all offer as taxpayers for the wholesale funding of banks, which became pretty explicit in the middle of the crisis. ... The other reason ... was for reasons of equity. Asking the general population to accept a VAT rise, asking them to accept that there were going to be changes to welfare eligibility ... I thought it would be totally inappropriate not to ask the banking sector to make a contribution as well. ‘. This led him to argue that he was targeting a revenue sum from the bank levy rather than a particular rate ‘because we think that is an appropriate contribution that balances fairness with the competitiveness of the UK banking sector.’ (HC 350 2010/11 Qs270, 272 (Ev39-40))

The significant feature is that the levy applies to banks only (i.e. not to the real sector) and has tended to be increased to offset so far as the banks are concerned the effects of the reduction in corporation tax. Whilst this bank levy is not calculated on the basis of ‘excessive profits’ of the banking or financial sector, it does seek to levy an additional tax specific to one sector and to do so in response to notions of fairness.

### **Taxes on bankers’ bonuses**

The proposals to specifically tax the bonuses received by bankers and others have (largely) come to the fore in the aftermath of the financial crises of 2007/09. Performance related pay is advocated on the grounds of the provision of incentives,



leading to greater effort and better performance. An alternative to the taxation route is forms of regulation on the extent of variable pay ('bonuses') and requirements that above some level specific approval from shareholders are required.

The European Commission, amongst many others, argued 'that annual bonuses' intrinsic philosophy encourages excessive risk-taking as, in the absence of any "malus" or "clawback" provisions, recipients can only cash part of profits they generate without bearing the consequences of any losses in case of materialisation of the risk. ... These remuneration policy problems in the financial sector are not limited to directors' and managers' pay, but also extend to remuneration schemes at other levels, notably to those persons whose work involves risk-taking (e.g. traders) and whose remuneration for a variable part is a function of performance.' European Commission (2010a).

Such thoughts combined with the scale of the bonuses which were paid and the costs of bail-out of banks etc. led to some 'bank bonus' tax generally levied on a one-off basis. For example, in the UK 'a new bank payroll tax [was announced]: "a special one-off levy of 50 per cent on any individual discretionary bonus above £25,000" to "be paid by the bank, not the bank employee."' was announced to apply from the date of the announcement (December 2009) 'to the end of the tax year – 5 April 2010 – and raise "just over £500m". In the March 2010 Budget the Labour Government confirmed that the payroll tax would not be extended, though its yield has proved far higher than initially forecast: £3.5 billion in gross terms.' (Seely, 2014, p.1).

On a more long-term basis is the 'EU banker bonus cap', which took effect on 1<sup>st</sup> January 2014 capping bonuses at 100 per cent of salary unless at least 65 per cent of the firm's shareholders approve an increase to 200 per cent of salary could be viewed as a bonus tax with a 100 per cent tax rate above the specified cap level.

How far the financial sector was unique in the extent of and the effects of variable and performance related pay was questioned by Gregg, Jewell and Tonks (2011). They examined 'the pay-performance relationship between executive cash compensation (including bonuses) and company performance for a sample of large UK companies,



focusing in particular on the financial services industry, since incentive misalignment has been blamed as one of the factors causing the global financial crisis of 2007/08. Although we find that pay in the financial sector is high, the cash-plus-bonus pay-performance sensitivity of financial firms is not significantly higher than in other sectors. Consequently, we conclude that it unlikely that incentive structures could be held responsible for inducing bank executives to focus on short-term profits.'

(Abstract)

There have been many what may be termed mis-selling scandals within the financial sector. Some can be ascribed to the incentives within the system, though in some regards these incentives apply across the board when individual and group rewards are related to the volume of sales. This is re-inforced with financial products through complexity, lack of financial knowledge as well as fundamental uncertainty over the future. In the specific context of the financial sector, two issues stand out. First, where performance is measured in terms of sales of financial products of some kind then individuals may be pressured and persuaded to purchase financial products which are unsuitable for them but which yield additional pay for the agent. In the context of loans and mortgages, the sale of such products was rewarded at or near the time of the loan/mortgage arrangement though the loan/mortgage may later becoming a non-performing one. The agent faced incentives to agree to loan/mortgage even in circumstances where default on loan/mortgage looked likely.

One clear criticism which can be made relates to the dividing line between regular income and bonuses, and the ways in which in effect that dividing line can be shifted. If, for example, the payment of bonus comes from a relatively low level of performance being achieved such that basic competence in the job would lead to a significant bonus, then in effect what is treated as a bonus could be incorporated into regular pay, and thereby reducing being subject to a bonus tax.

It has been an ever present issue with performance related pay that what is treated as a 'good' outcome (to be rewarded by higher pay) may well result from 'good luck'



as well as from effort and skill. Further, how far what is measured as performance can be distorted.

### **Concluding comments**

A tax proposal can be variously judged. It may be judged in terms of the incentives and disincentives which are involved and the effects which the tax may have on behaviour and decisions. On those grounds the ideas on taxing banker bonuses and variable pay fall into that category through seeking to discourage elements of variable pay. The key question to be asked here is, if such is indeed a main objective of such a tax, how effective such a tax would be as compared with the alternative policy, notably regulation and codes of practice. It could be expected that such a tax may be relatively easy to circumvent through a change in the reported balance of basic and variable pay. Further, it may be questioned how well targeted such a tax would be in terms of discouraging the behaviour within the financial sector which was deemed to be particularly detrimental and a contributory cause of the financial crisis. Variable pay in the financial sector would be particularly targeted in the belief that its effects were particularly detrimental as compared with the effects of variable pay in other sectors, through the encouragement of excessive risk taking. But, variable pay, performance related pay and bonuses are deemed to provide incentives for good performance (however that is judged). If it can be taken that some aspects of performance related pay is overall beneficial, the question would be how far a tax on variable pay can be focused on the aspects which are overall detrimental.

A tax may also be judged in terms of 'distortions' which are introduced – in the sense that the taxed activities are treated less favourable than untaxed activities, and more resources will be engaged in the latter than the former. The relative undertaxation of the financial sector as a result of its general exemption from value added taxation could be seen as introducing such a distortion, and a financial activity tax has merits in correcting such a distortion. It also has the merit of being relatively straightforward to implement as discussed above.



Income distribution considerations are also involved. They have not played a much of a role in the consideration of financial sector specific taxation, though it may be remarked that variants of the financial activities tax where the scale of the activity is measured in terms of 'excessive' returns and economic rent. As such there would be overlap with ideas of 'excessive profits' and windfall taxes which have at their heart notions that profits above a certain level are in some ways unfair, exploitative and do not reflect efficient performance.

Proposals for some form on taxation relating to the financial sector (e.g. some form of 'excessive profits' tax, tax on bonuses/variable pay in the financial sector) often to seem to come from a combination of reactions to some element of scandal/poor behaviour and hypothecation whereby the yield from the tax is ear-marked for some named (new or extended) programme. The latter element may have some rhetorical appeal – it appears to answer the question of 'where is the money coming from' but it otherwise does have much appeal. The two elements should be in effect judged on their own merits – that is the questions to be asked is the tax a 'good one' (however that many be judged) and is proposed expenditure socially beneficial. Taxation of the 'excessive profits' variety are retrospective in nature and as such do not directly affect behaviour – though of course expectations of future taxes may be formed and influence behaviour. The taxation of 'excessive profits' may rather be seen as an income distribution matter.

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## THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

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1 (Coordinator)	University of Leeds	UK
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3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
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