



# TAX AND THE FINANCIAL CRISIS(ES)

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Views should not be attributed to the IMF

- Looking back—Did tax have a hand in the crisis?
- Looking forward – Does it have a role in preventing/limiting future crises?

LOOKING BACK...

- Tax didn't *cause* the crisis—no triggering tax events
- But might long-standing tax distortions have made matters worse?

# Debt bias

Issue is the asymmetric CIT treatment of interest (deductible) and equity return (not)

Tax preference for debt may have fallen for high rate PIT payers since 1980s...

...but still substantial — and perhaps amplified by (1) growth tax exempts/non-residents (2) greater ease of exploiting it

## Does debt bias matter?

- Debt-equity (D/E) ratios did not ramp up prior to crisis — except LBOs, Investment banks, UK banks
- But debt decisions are tax-sensitive, so D/E higher than otherwise...
  - ...perhaps by quite a lot: a 20 percent CIT might raise D/E from 40 to 45-60 percent

In welfare terms, standard deadweight loss quite small (and hybrids may reduce it)

But:

- Pre-existing distortions (e.g. in financial sector) can amplify welfare loss
- Impact on systemically important FIs would be a concern
- External effects may be large: e.g. higher D/E associated with larger post-crisis output declines

Are reasons why banks have high D/E ratios:

- Traditionally, safer/lower risk; deposit insurance

But:

- Tax bias to debt runs counter to regulatory requirements (which, NB, commonly do not bite)
- Tension reflected in devices that enable debt-like instruments to be treated as Tier 1 capital

# Housing

- Favorable tax treatment wasn't necessary for a 'bubble' (UK), nor was it sufficient (Italy)
- Evidence does suggest favorable tax treatment is associated with higher household mortgage debt
- Non-taxation of imputed income the deep distortion to housing markets...
- ..and so long as it remains, strong case for phased exit from mortgage relief (as UK)—after recovery takes hold

# Complex instruments

- Development and use partly tax-driven
- Tax changes may have facilitated securitization, in sense of removing impediments to tax-free intermediation
- Lingering uncertainties on tax rules may itself encourage complexity—e.g. no IRS ruling on CDS

- A role in subprime securitization?
  - For individual holding a mortgage, capital loss on defaulted loan deducted at lower rate than interest on non-defaulted is taxed
  - By mixing mortgages together, losses effectively set against interest income
  - Who would sell such packaged mortgages? Mark-to-market trader taxed symmetrically. Who would buy? Personal taxpayer.

Holding patterns don't seem consistent with this

## Wider issues:

- Game-playing will remain so long as capital income taxation remains incoherent
- When does financial innovation ease welfare cost of tax distortions (revenue aside)...
  - e.g. hybrid instruments (maybe)...and when does it worsen them?

LOOKING FORWARD

Context is of:

- Substantial regulatory reform coming (higher capital requirements, leverage ratios...)
  - Need to assess tax in combination with this (more than we have before)
- Heightened revenue need in many advanced economies
  - From aging, more than crisis

First, do no harm — fix tax distortions that go the wrong way, notably debt bias:

- Thin cap rules? — arbitrary and complex
- CBIT (no interest deduction)?
- ACE (deduction for notional return on equity)?
  - for financial institutions, mean deduction for return on Tier 1 capital

Perhaps also renew attention to VAT and FS

- Second, better align tax and regulation.  
E.g.

- What tax rules for dynamic provisioning?
- Reduce scope for game-playing with use of tax losses to build regulatory capital?

- Third, should we go beyond traditional prescription of neutrality in relation to the FS?

Much talk of ‘externalities’ — but what *exactly* are they, and where ultimately from?

- Limited liability/TBTF? Interconnectedness?  
Short-term funding? Fire sales? Financial transactions per se?

And is tax the best way to address them?