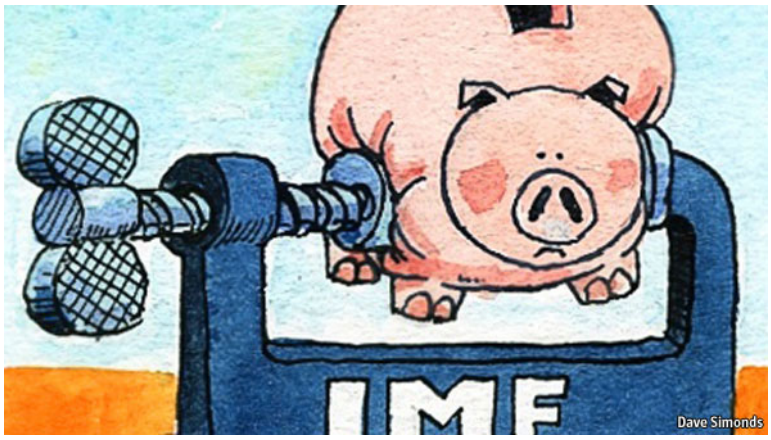
Stick 'em up

The IMF's proposals to tax the banks will be popular, but are incomplete.



THE IMF used to be accused of clobbering little people in order to protect Big Finance. Now it is devising ways to squeeze the banks in order to defend society. Its proposals for taxing the world's financial firms will be debated by the G20 in June. Any banker who assumes they are another bit of theoretical wonkery should think again. Many hard-up Western governments now have a recipe for raising levies that are lucrative, wildly popular and come with the imprimatur of capitalism's policeman. Surely it can't get better than that?

Actually, it could. As a central part of the world's response to the problem of too-big-to-fail finance, the proposals get only a B-plus. They include one good idea (arrived at for fuzzy reasons), one bad idea and one missed opportunity.

The good idea is to tax part of financial firms' liabilities—crudely put, their debt. When banks are deemed too big to fail, they can borrow abnormally cheaply. This funding subsidy is at the root of many evils. It is why bankers' fat bonuses, paid from profits boosted by cheap funding, are unfair. It gives banks a potentially dangerous incentive to get bigger and riskier. And it is why badly run firms can still command market confidence. Where such a subsidy exists, taxing it back to tackle these perverse incentives is both just and essential.

The IMF proposes just such a tax, but it is rather vague about why. It wants banks to pre-pay for the next crisis, which it reckons might cost 2-4% of each country's GDP, with the levy probably going into a bail-out kitty. A tax specifically designed to recapture the subsidy might actually be higher than this. And there is some quirky fine print. By casting the net widely, the IMF seems to include insurance companies, even though their main liabilities are reserves for payments to customers, something no one should have a problem with. And though its desire to tweak the tax to reflect firms' risk to the system is understandable, it risks duplicating new rules on bank capital.

Treating the symptoms, not the cause

The bad idea within the proposals is that banks should have to pay a further tax on their profits before pay. It is not clear why. If the idea is to get banks to pay for their funding subsidy, then the IMF's first proposal already does that, and should simply be made bigger. If society's tolerance for high pay is the problem, then personal tax rates should be the tool. And if the authorities want to try to discriminate between firms, then it is a bad idea to tax those banks that are consistently profitable. Over the past three years they have mainly been traditional, deposit-taking firms, often in emerging economies. Finally, if there is a broader desire to tackle excess profits that banks may make from colluding with each other or

confusing customers, then the answer is to try to address those problems directly, through antitrust or consumer-protection regulation, rather than simply skimming the cream of the cash made.

That last argument, of course, also applies to the funding subsidy banks get. Why not try to eliminate it, rather than recoup it? The IMF proposals rightly highlight the importance of a resolution authority that would allow banks to fail in an orderly way. But this is the missed opportunity. Everybody who looks at the “too big to fail” problem grapples with the idea of a bankruptcy body for banks; but no one has truly resolved the Catch-22 at the heart of it. As things stand, no resolution authority can push losses onto creditors, rather than taxpayers, without sparking a run as counterparties flee in expectation of pain. The state will then be forced to make huge loans to dodgy firms, as was the case with AIG and Royal Bank of Scotland. What is needed is not just an agreed system for dealing with failing banks but also an agreed line between creditors that would still be protected (the bulk of them, including most trade counterparties) and those who would not—and whose debts might be turned instantly into equity in the failing entity.

The IMF was not asked to look at this, but it has missed a chance to prod the G20 in the right direction. Now it will have to make the case for its taxes. A few rich-world dissenters, such as Canada, along with most emerging countries, are reluctant to clobber banking systems that have done well. The result of the IMF’s plans could well be a global tax of symbolic value, set at a very low rate. That will still leave banks that cannot fail, but by then the world may have moved on to an even trickier question: what should the bail-out kitty invest in? Mortgage securities, perhaps, triple-A rated and arranged by Wall Street’s finest. What could possibly go wrong?

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