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The Financial Crisis Responsibility Fee, President Obama's new plan for special levies on banks, is astute politics. Its economic impact is likely to be negligible, but that may be the whole point.

It contrasts with the approach being taken by regulatory bodies internationally. The conclusion of researchers is that the problem leading to the recent financial meltdown is the lack of attention to "systemic risk."

Financial institutions showed themselves extremely vulnerable to "systemic risk"--problems that hit the entire financial sector at the same time. It turns out that financial institutions over the past decades had become increasingly sophisticated at handling risks that hit them in isolation or as a result of well-understood fluctuations in the financial and economic markets, but had not taken sufficient account of the risks that arose from the "knock-on" effects of financial difficulties of their counterparties. To a degree this problem has solved itself: if anything financial institutions are now excessively concerned with the dangers of counterparty risk. Still, the financial crisis has revealed a structural weakness in the financial system: no financial institution will ever take sufficient account of the consequences of its actions in contributing to a financial meltdown, because the costs of such a meltdown will never fall fully on the institution.

And so regulators internationally are focusing on arrangements, in particular taxes or fees, to discourage "systemic risk-taking." Analysts and central bankers have been considering a bunch of interesting and difficult questions with regard to such a program: in particular, what are the right measures of a firm's contribution to systemic risk, how should these measures vary over time or circumstances--and should the proceeds of such a tax should be put into an insurance fund or returned as general revenues to the government.

Any plan adopted will have to face a serious problem: what are the boundaries of the set of institutions on which the tax is imposed? If the tax is imposed unevenly across countries, the institutions simply migrate. If it is imposed on institutions with particular labels--banks, intermediaries, hedge funds--the institutions simply metamorphose. These are not idle concerns: the history of financial regulation and innovation is riddled with examples where a government's attempt to control a financial institution's activities simply led to the development of a new institution or a new financial center which took over the activity under a different label. Given the difficulties, it's reasonable to ask whether regulators should be trying so hard to adjust financial institutions' incentives in these ways, or to focus on how make crises less damaging when they do arise.

Of course the politics of the situation has nothing to do with any of these considerations. There are a bunch of politically winning explanations for imposing the tax as punishment on financial institutions: punishment for their role in the economic downturn, for the costs they imposed on the Federal Reserve and the Treasury in responding to the financial crisis, for the vast amounts of money they made in the past decade and in the past year, for the excessive pay they provided their top employees. All of these explanations will be satisfying to voters. But in reality they will be poor justifications of any permanent program. Trying to tie the tax to costs imposed on the U.S. taxpayer is hopeless: direct costs associated with any particular surviving institution are likely to be recouped anyway, indirect costs are impossible to associate with one institution over another. If the objection is to employees making too much money,

then the solution is the taxes that already exist. In the case of the employees themselves, trying to prevent this is unlikely to be effective, if the preliminary evidence from the reaction to a similar proposal in the UK is anything to go by. If bad PR won't cap compensation, then taxes are unlikely to do so. To the extent that these employees are highly mobile (internationally and among jobs) and to the extent that they are paid competitively (and both of these assumptions seem pretty reasonable) then basic economic theory says that the financial industry will just swallow the employee taxes in the short run, and move the business elsewhere in the long run.

But the Obama proposal isn't for a permanent tax; it's instead a temporary levy associated with reparations for the past crisis. Perhaps the political logic is this: if we make the fat cats howl loud enough, then public opinion will be assuaged, and no new permanent system will be necessary: the pound of flesh will have been extracted, and financial institutions can return to normal--well, not quite normal, since the experience of the last two years is a lesson which financial institutions have indeed learned--but without subjecting the system to a new overarching tax structure. On the other hand, the current proposal is for the assessment to be paid over the next ten years--long enough to make it into a habit.

If you think that more is needed to discourage systemic risk (and I guess I do), then you have to hope that the new regulatory powers of the proposed systemic risk regulator (whether the Fed or a hybrid agency) are sufficiently strong.

If you worry about the precedents of levies targeted on firms after the fact (and I guess I do), then you have to hope that Congress regards the situation as sufficiently exceptional so as maintain self restraint in the future. Even if you are confident that Congress can limit itself to punishing for behavior which is clearly bad for the economy, not just behavior that rubs some powerful senator the wrong way, you have to worry about the effectiveness of collective punishment: This tax cannot successfully discriminate between institutions that caused the crisis and institutions which ameliorated the crisis (sometimes the same institutions); indeed, on the same grounds, you might as well tax members of Congress for their role in the crisis.

In other words, it's a balancing act: how do you stage the maximum of perceived revenge with the minimum of damage to the financial system itself?