

The Governance of Macro Prudential Taxation

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The G20 countries will seek to coordinate in April their bank taxation choices, and the debate focuses now on the best tax base.

The US tax proposal targets the stock of uninsured bank liability, as they were bailed out in the crisis. This proposal is a reasonable claw back tax, to repay past bailout costs. Yet what is needed is a forward looking tax which target future systemic risk creation. It should discourage future choices which cause local shocks to propagate across markets, multiplying their impact and disrupting the economy.

We review here the key design issues in setting up a macro prudential policy framework. A critical distinction is between aggregate risk creation, which is highly correlated with the business cycle, and systemic risk creation in credit booms. The financial cycle has a higher frequency and potential amplitude, and can exacerbate economic fluctuation unless contained in a timely fashion.

Sources of risk and assignment of responsibility

Aggregate risk factors tend to arise on the asset side, so it is the prime task of financial regulators. Aggregate asset risk factors, such as correlated holdings of long term assets, can be targeted with countercyclical capital requirements and regulation (such as prudential limits, rules on disclosure and clearing arrangements).

With hindsight, the most glaring gap in Basel II was its neglect of unstable short term funding. Rapid capital withdrawals was the primary source of propagation in the last crisis. This occurred in combination with opaque assets. Yet other episodes of opaque asset overvaluation, such as the internet bubbles, produced huge losses but basically no propagation across markets. The explanation is simply that these investments were funded with equity. Once losses materialized, investors could not escape, and took their losses without spreading them.

Because of the different nature of asset and liability risks, there is a strong case to separate the tasks of controlling them. Asset risk is the natural remit of micro financial regulators. The control of liquidity risk is already a central bank task. In the event of a crisis, only the liquidity support function of central banks can contain propagation. It is natural to assign to macro prudential councils, where central bank are well represented, the task to manage the systemic risk arising from panic withdrawals of short term funding.

Controlling propagation risk via liquidity risk charges

A systemic levy which targets unstable funding should focus on uninsured short term liabilities (including repo's). Wholesale funding allowed the massive expansion in securitized lending, yet escaped before bearing any losses. A liquidity risk levy (Perotti and Suarez, 2009) charge intermediaries relying on fragile funding for the negative externality they create for others, when they make fire sales to repay rapid withdrawals of funding. Such levies also charge intermediaries ex ante for the de facto insurance of uninsured liabilities, though without creating an explicit insurance promise.

Liquidity charges are aimed at future incentives, discouraging rapid asset growth funded by investors bearing no risk. It aims at increasing maturity from the current absurd over reliance on overnight repo markets, thus increasing financial resilience to shocks. They should be scaled by bank size, to tackle the too-large-to-fail problem, and by interconnectedness, to control intermediaries which cannot be easily extricated from others.

Liquidity charges would discourage intermediaries from scaling up their balance sheet via huge proprietary trading desks, without imposing Glass Steagall restrictions. It is essentially an opportunity cost to discourage large scale, uninformed carry trade strategies invested in securities that earn on average a risk premium without providing any useful monitoring. This should be distinguished from informed bank lending, an useful maturity transformation task by delegated monitors (banks) which deserves public support.

Assignment of revenues

The optimal configuration probably requires granting rate setting powers to prudential supervisors, but allocating revenues to the Treasury.

It would be inappropriate to store these revenues in a bank stability fund, as a prepayment of future support. The first objection, by itself more than sufficient, is that funds create moral hazard and breed complacency, as previous episodes suggest. But the main argument is purely fiscal. The overwhelming fiscal cost of the crisis has not resulted from direct injections in the financial system, which were in the end modest, but by reduced taxes and spending enacted to cushion its impact on the economy. A small fraction of revenues may be allocated to a burden sharing fund to resolve cross border failures.

Assigning responsibility for taxation of liquidity risk

Systemic levies are basically taxes, as they need to be levied on all relevant intermediaries, including the shadow banking system.¹ Taxes are the domain of finance ministries, not financial supervisors. Yet systemic charges are a natural macro-prudential tool for financial stability, and need to be adjusted *preventively and in a timely manner*. Such policy choices are a natural attribute for central banks, in charge of both liquidity insurance and monetary stability, in consultation with micro regulators (the envisioned ESRB combines such policymakers).

Delegating general levies to a macro prudential authority does not require a Copernican shift, as central banks play an indirect fiscal role already by the seignorage tax they raise on liquidity holdings. A simple solution is to separate a basic tax and time-varying surcharges, the latter to be coordinated by a macro prudential council where central banks play a significant role. As it is the case with seignorage, the revenues from surcharges ultimately flow to the Treasury.

¹ Even if liquidity levies were charged only to banks, they would increase the cost of banks' contingent exposure to the shadow banking intermediaries, removing the critical transmission channel and discouraging liquidity risk creation outside the banking system.

Reserve requirements

Ultimately, an optimal policy to control liquidity risk may involve a combination of liquidity charges and reserve requirements, currently assessed in the Basel process.

A first advantage of having *also* liquidity charges is that they are less distortionary, just as tariffs are over quota. More critically, charges can be adjusted more smoothly than quantities. They avoid the trigger risk caused when wholesale withdrawals lead all banks to seek to rebuild their buffers at the same time. They are easier to extend to nonbanks, which have no monitored reserve obligations. Last but not least, they raise more fiscal revenues with less distortionary effects.

Public accountability of macro prudential councils

A critical governance issue is public disclosure of recommendations by macro prudential authorities. This is indispensable to overcome regulatory delay, as failure to act in a timely manner will be visible. Public announcements support timely intervention, and enhances the accountability of macro prudential policymakers. It enables to act at an early stage with small adjustments which signal clear resolve to contain risk creation. Finally it has the advantage to create pressure to coordinate systemic tax rates across countries.

A concern of public announcements is whether they may shake markets. Yet under timely intervention with small adjustments, the system will not be allowed to become so overexposed, and higher taxes would not trigger a large market response.

Conclusions

The right combinations of tools and responsibility can finally establish capability and incentives for policymakers to enact a truly preventive macro prudential policy.

Ultimately, new tools must finally enable us to separate financial stability, which requires prompt corrective action, from macroeconomic stabilization policy, which must steer the slower business cycle. Systemic levies can tighten financial discipline without a large increase in interest rates for the whole economy, avoiding a main cause of reluctance to act on a timely manner to contain systemic risk.

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