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Statement of the Shadow Financial Regulatory Committee on

Proposed Tax on Large Banks Is Poorly Designed and Premature

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On January 14, the Administration proposed that large banks (those with consolidated assets above $50 billion) be taxed to reimburse the federal government (and thus taxpayers) for the costs of the Troubled Asset Relief Program (TARP). The Administration justified this proposal through a provision in the legislation creating the TARP (The Emergency Economic Stabilization Act of 2008) that requires the President to propose to Congress by 2013 a mechanism for achieving this reimbursement. The Shadow Committee believes that the specific proposal, however, is poorly designed and premature (though some kind of reimbursement might well be appropriate in the future).

The Administration's proposal should be considered in light of both the original purpose of the TARP, and how the TARP has actually been used. At the time, Secretary of the Treasury Paulson persuaded Congress, that the TARP was to be used to finance the purchase of so-called "toxic assets" (primarily complex mortgage securities) from troubled banks. The final legislation included fallback language allowing the Treasury also to use TARP funds to purchase stock in troubled banks.

Shortly after the TARP was created, the Treasury replaced its plan to purchase toxic assets by a plan to inject capital into the nation's largest banks and bank holding companies and, subsequently, into many others institutions as well. In addition, TARP funds were used to prop up some insurance firms, finance companies, General Motors, and Chrysler. Some funds have now been repaid by the banks and the Administration has proposed using TARP funds for other purposes, such as providing funding for small business loans by community banks. Separately, the Federal Reserve and the Treasury spent or committed a little over $182 billion to support AIG; some of this total involved TARP funds and some came directly from the Federal Reserve's own resources. Today the TARP program threatens to become the functional equivalent of a slush fund to finance other activities.

The Administration now proposes to tax large banks (and only large banks) to pay for net costs of TARP. The proposed assessment of 15 basis points would be levied for 10 years on what essentially amounts to the uninsured liabilities of these institutions (total assets minus insured deposits and Tier 1 capital).

The Shadow Financial Regulatory Committee has three major objections to this particular proposal. First, it asks banks to pay for the costs of rescuing non-banks, such as auto and insurance companies. This proposal lacks fairness and is inconsistent with the purposes for which TARP was initially created. TARP was created to save the financial system, not other parts of the economy. It distorts the purpose of TARP to make some banks pay for the costs of rescuing non-bank firms.

Second, the Administration frames the proposed tax as a way to make beneficiaries of bailouts pay for the costs of those actions. To apply that principle, however one needs to measure the extent that others benefited from activities that purportedly saved the financial system beyond just the nation's largest banks. TARP directs, however, that taxpayers bear the costs of TARP but leaves broad discretion as to what parties would be taxed. Nonetheless, if taxpayers are to be spared these costs, then clearly some larger group of enterprises – all banks, all financial companies, and for that matter, all firms (financial and non-financial) – should be called on. The Shadow Committee surmises that large banks might have been singled out because they are currently politically unpopular. But that motivation would not provide for a principled basis for recovering the costs of TARP. Furthermore, the Committee observes that if a tax is enacted, a portion of its costs would be shifted onto lenders or borrowers (or their customers) formally subject to the assessment.

Third, the proposal to require reimbursement at this time is premature. It will take some time to know what the net cost will be of rescuing banks in particular (the intended initial beneficiaries of TARP). That figure is a moving target, and will be for some time. In proposing the tax in January, the Administration claimed that the net cost of TARP (including costs for rescuing the non-banks) would be $117 billion. But that figure, as large as it is, was down from an estimated loss of $341 billion just five months earlier (August 2009). With a change in estimated costs to be reimbursed of $240 billion over a short time, it obviously is premature to impose a tax now, when even the January 2010 figure almost surely will change.

The Committee therefore recommends that policy makers wait until we have close to a final accounting of the cost of the TARP, for the purpose of rescuing banks. The legislation creating the TARP in fact deliberately gave the Administration until 2013 to come up with a reimbursement system. There is no need, therefore, to rush to judgment on the amount of the required reimbursement. And when a final or near-final accounting is ready, the costs should be assessed at least across all banks, if not an even broader array of institutions.