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REAGAN'S TAX REVOLUTION: MIXED BENEFITS FOR FINANCIAL INSTITUTIONS

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INTRODUCTION

Ronald Reagan's tax reform package has two broad goals. It is intended to simplify the system, ending complex and unreasonable tax devices that benefit accountants and special interests rather than the average taxpayer. And it seeks to reduce the tax rates for individual taxpayers by removing certain deductions and by increasing the burden on corporations.

The generally increased business burden, of course, is a hidden tax on individuals because ultimately only people can pay corporate taxes--as stockholders or the purchasers of more expensive goods. In some cases the burden would be particularly onerous. Financial institutions, for example, would pay $2 billion extra, significantly cutting into this industry's nationwide profit of just $10.6 billion last year.

Yet despite the damaging impact of the tax hike on financial institutions, the tax reform elements in the Reagan package merit

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This is the fourth in a series on the President's tax reform plan. It was preceded by "Reagan's Tax Revolution: Ending the Free Ride for State and Local Taxes," Issue Bulletin No. 114, June 14, 1985; "Reagan's Tax Revolution: Fair Play for Energy," Issue Bulletin No. 115, July 10, 1985; and "Reagan's Tax Revolution: A Big Boost for Families and the Poor," Issue Bulletin 116, July 25, 1985. Future studies will examine the plan's impact on international finance and trade, and savings, investment, and risk-taking.

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serious consideration. The package, for instance, advances the general policy of deregulating financial institutions, letting firms compete on a more equal tax basis within the industry, and eliminating many complicated tax preferences that give certain sectors advantages over others. While all this should benefit the economy, the problem is that it comes at the price of higher taxes.

Advocates of the Reagan proposals claim that financial institutions can afford the higher taxes because the industry is generally undertaxed. This is untrue; the industry is not undertaxed. Yet it may be unwise, from the perspective of financial institutions, to reject the Reagan proposals because their structural elements will help the industry. They will introduce technical changes that in effect will promote deregulation of the financial institution industry and allow that industry to be treated similarly to other sectors of the economy.

ARE FINANCIAL INSTITUTIONS UNDERTAXED?

Yes, say critics of the industry, pointing to a Joint Tax Committee report of last year that found financial institutions paid an average 6.4 percent tax rate on income earned in the U.S. Yet such statistics are extremely misleading unless coupled with the findings that financial institutions paid a tax rate of 39.1 percent on foreign-source income. As such, the financial institutions' tax rate on their total earnings was 24.3 percent. By comparison, all U.S. corporations paid a worldwide tax rate of 29.2 percent.[1]

Even these broader measurements of taxation greatly underestimate the tax paid by financial institutions in two important ways:

First, financial institutions are required by law to maintain reserves, consisting of cash in their vaults or deposits at the Federal Reserve, neither of which earn income. Though some reserves are clearly necessary, the Federal Reserve generally requires reserves to be much higher than market conditions demand. The forgone income on such reserves constitutes a tax

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1 Joint Committee on Taxation, Study of 1983 Effective Tax Rates of Selected Large U.S. Corporations, Joint Committee Print, 98th Cong., 2d session (Washington: U.S. Government Printing Office, 1984). See also Bruce Bartlett, The Federal Tax Debate: How Much Should Corporations Pay? Heritage Foundation, Backgrounder, No. 402, January 8, 1985, pp. 2-7. See also Don Fullerton, "Which Effective Tax Rate?" National Tax Journal 37 (March 1984), pp. 23-41.

borne by financial institution stockholders in the form of lower dividends or by the depositors in the form of lower deposit rates, higher borrowing rates, or reduced services.[2] This implicit tax can be calculated only roughly. In 1984, financial institutions held reserves of $38.71 billion (not counting vault cash). If they had earned a return on these reserves equal to the interest rate on three-month Treasury bills, financial institutions' profits would have increased $3.7 billion, or about 25 percent. In effect, the reserve requirement imposed a 25 percent "profits tax."

Second, financial institutions tend to hold large amounts of their assets in the form of tax-free municipal bonds. It is misleading, however, to view such bonds as entirely free of tax because they pay interest rates significantly lower than those available on other instruments. In 1984, for example, the average interest rate on municipal bonds was 10.15 percent, compared to 12.71 percent on high-grade corporate bonds. Hence, a municipal bond purchaser already pays an implicit tax of more than 20 percent before paying any direct taxes--a tax which, in effect, goes directly to state and local governments in the form of reduced borrowing costs. (Needless to say, elimination of a prime market for municipal bonds would probably raise yield on municipal bonds and therefore the cost of financing state and local capital expenditures.).

Financial institutions, moreover, are not among the nation's most profitable industries. Indeed, one of the most serious problems faced by the U.S. economy is the weakness of many financial institutions, ranging from giant Continental Illinois to small country banks and savings and loans in Ohio and Maryland.[3]

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[2] Stuart E. Weiner, "Payment of Interest on Reserves," Federal Reserve Bank of Kansas City Economic Review (January 1985), pp. 16-31; G.J. Santoni, "The Monetary Control Act, Reserve Taxes and the Stock Prices of Commercial Banks," Federal Reserve Bank of St. Louis Review (June/July 1985), pp. 12-20.

[3] Another point worth keeping in mind is that the profits of financial institutions included in the National Income and Product Accounts are largely those of the Federal Reserve System, which, for some unknown reason, is treated as a private entity, rather than a governmental entity. Therefore, one must net out the Federal Reserve's earnings (which are largely repatriated to the Treasury) in order to get an accurate picture of bank profits. In 1984, for example, the National Income and Product Accounts reported total corporate profits in the financial industry (which includes, in addition to banks and savings and loans, stock and commodity brokers, insurance companies and others) of $27.3 billion. Of this, $16.7 billion, or almost two thirds, were the Federal Reserve's profits.

Historically, bank stocks have been poor investments. Since 1941, the Standard & Poors 500 index has increased about sixteen-fold, while the S&P index of bank stocks has risen only six-fold. Since 1973, while the S&P 500 has increased about 50 percent, the bank stock index actually fell. This suggests that banks cannot easily bear the burden of additional taxation.

WHAT THE REAGAN TAX PLAN WOULD DO

The President's tax plan proposes five changes affecting financial institutions. It would change the bad debt reserve deductions, disallow interest incurred or funds used to purchase and hold tax-exempt securities, repeal the tax exemption for large credit unions, end the special operating loss carry-over rules for depository institutions, and cancel the special reorganization rules for troubled thrifts.

1) Bad Debt Reserves

The tax proposal states that "the special rules for commercial banks and thrift institutions for computing additions to a bad debt reserve should be repealed." This means that commercial banks and thrifts would be able to deduct bad debt losses only at the time that they occur. Current law allows such depository institutions to deduct additions to bad debt reserves using methods unrelated to the present value of their expected losses. There is a complicated formula which detemines the method by which they deduct bad loan reserves.

Three reasons are given for changing the rule to make only current losses tax deductible: 1) the deduction of additions to bad debt reserves is said to be essentially a deduction for future losses; 2) depository institutions receive more favorable tax treatment for loan losses than lenders in other industries; and 3) the investment decisions of depository institutions may be distorted by the tax treatment of bad debt reserves.

Administration officials argue that existing bad debt rules provide "a significant subsidy for depository institutions and substantially distort the measurement of their income." This argument seems to ignore the banks' and thrift institutions' serious financial difficulties of recent years. The existing deductions for additions to bad debt reserves thus may be needed to help strengthen the solvency of these institutions. Similarly, the existing tax treatment of bad debts could be seen as offsetting the interest income lost by depository institutions on required reserves.

2) Deduction for Interest that Carries Tax-Exempt Securities

Current law allows depository institutions to deduct most of the interest cost of deposits that financial institutions use to purchase tax-exempt securities. Advocates of the Reagan changes complain that the current law permits depository institutions to shelter income from taxes and thus encourages depository institutions to make financial investments that are not optimal from the viewpoint of economic efficiency. It is also argued that commercial banks and thrift institutions have a competitive advantage over other lenders which cannot deduct any portion of interest on loans used to purchase tax-exempt securities. Reagan tax plan backers further maintain that income should be matched with its cost of production. As such, they say, deductions should not be allowed for interest paid on deposits that are used to purchase tax-exempt securities.

These arguments warrant consideration. It is difficult to justify why financial institutions should enjoy a special tax break to purchase assets (such as municipal bonds) that already provide tax relief. Such specialized relief, moreover, encourages a misallocation of resources. To be sure, eliminating the deduction for interest to carry tax-exempt securities would make it more difficult for state and local governments to market their securities at rates below those paid by the U.S. Treasury and blue chip corporations. This could put pressure on cities and states to raise revenues by other means, such as tax hikes. But this is a choice that local governments should face. Providing special federal tax relief to encourage expenditures by state and local government violates a key element of the Reagan tax reform--elimination of the income tax deduction for state and local taxes.

3) Repeal of the Tax Exemption for Large Credit Unions

Credit unions are now exempt from federal, state, and local taxes on all income--whether it is retained or distributed to depositors. Tax-free retained earnings of credit unions can also accrue tax-free interest. The Reagan tax proposals would eliminate this because it is viewed as giving credit unions a competitive advantage over other depository institutions.

A case can be made for the change. Broad deregulation of all types of depository institutions requires that they all be treated equally. Credit unions, moreover, already have benefitted from deregulation which permits them to offer more consumer services. As such, it would seem fair to impose the same kind of tax treatment on credit unions as on other financial institutions.

Credit unions disagree. They assert that they differ from other depository institutions since they are "member driven" rather than "profit driven"--that is, more like associations than businesses. This argument, however, indicates that credit unions want it both ways. Either they are unique nonprofit institutions, in which case they should not be allowed to engage in tax-free competition with commercial institutions, or they should be free to compete on the same tax basis as other institutions.

4) Repeal of Special Rules for Net Operating Losses of Depository Institutions

Depository institutions now enjoy special tax treatment of net operating losses. Example: the losses can be carried back ten taxable years preceding the current year or carried forward five taxable years after the current year. Other taxpayers, however, generally can carry net operating losses back just three years or forward fifteen years. Businesses typically prefer carrying a loss backward to carrying it forward, since carrying it backward can provide an immediate tax refund; carrying it forward merely reduces future tax liabilities. The Reagan proposal would repeal the depository institutions' special tax treatment of net operating losses.

This is probably sound policy. There seems little reason why financial institutions should be treated differently from other businesses. The Reagan proposal thus is in line with the principle of tax equity and simplification.

5) Repeal of Reorganization Rules for Financially Troubled Thrift Institutions

Acquisition of stocks or assets of one corporation by another now generally qualifies as a tax-free reorganization only if "continuity of interest" exists, that is, the shareholders of the acquired corporation receive a significant continuing equity interest in the acquiring corporation. Special rules enacted in 1981 allow acquisition of financially troubled thrifts to take place on a tax-free basis even if they do not satisfy the continuing interest requirement. Backers of the Reagan tax proposal maintain that these special tax rules hide and probably increase federal subsidies, because some thrift losses are, in effect, shifted to the government in the form of lower taxes for the acquiring institution. The tax proposal seeks to repeal these special rules.

Since a central purpose of the tax reform is to simplify the code and remove special tax advantages for favored interests, the elimination of these rules seems justified.

CONCLUSION

The financial industry, as corporations in general, will bear an increased burden of taxation under the Reagan proposal. This would not seem advisable, in view of the current plight of so many financial institutions. Nevertheless, the Reagan tax proposal does "level the playing field," by eliminating some of the disparities in the taxation of different types of financial institutions. It would be be far better, however, were this accomplished in a way that did not require an increase in taxation.

Although the tax increase on the financial industry is relatively small, it must be seen in the context of the overall low profitability and the continuing problems of many firms in this industry, as manifested by record numbers of bank and thrift institution failures. Since the amount of revenue potentially raised is quite small in the aggregate--about $2 billion per year--this tax increase should be reconsidered.

Nevertheless, the tax proposals relating to financial institutions do satisfy one important goal of tax reform: achieving tax neutrality, by reducing the tax differential among financial institutions. Whether this justifies the overall increase in taxation must be judged in the context of overall tax reform.