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Camp Bill Keeps Good Debate Going, but Bank Tax Embeds "Too Big to Fail"

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Ways and Means Committee Chairman Dave Camp (R–MI) has performed a valuable service in highlighting the need to reform the tax code, but the draft proposal falls short of what is needed. In particular, the plan's new "bank tax" would embed the anti-market principle that certain financial companies are too big to fail. The bank tax would actually magnify the government's incentives to bail out troubled firms, because it creates a funding source to ostensibly pay for future bailouts.

Too Big to Fail. The 2010 Dodd–Frank legislation was supposed to eliminate taxpayer bailouts of private companies, the problem known as "too big to fail" (TBTF). But many experts, such as former president of the Federal Reserve Bank of Minneapolis Gary Stern, acknowledge that bailouts are at least as likely now as they were prior to Dodd–Frank.[1] The typical justification for TBTF is that some businesses are so large and interconnected that their bankruptcy would cause an economic disaster, which warrants propping up these firms with taxpayer money. However, it is very difficult to prove whether allowing one of these troubled firms to fail really would cause disastrous ripple effects throughout the U.S. economy.

While the Lehman Brothers failure in September 2008 is often cited as a main cause of the financial crisis, the truth is much more complicated.[2] For starters, bankruptcy is one of the main ways that markets rid themselves of unsustainable economic activity. Additionally, a very good case can be made that the decision to bail out Bear Sterns *and then* let Lehman fail did more harm to the economy than just Lehman's failure. And even though it is difficult to parse out the impact of Lehman's bankruptcy, other large business failures, such as Enron and WorldCom, did not lead to economic disasters. These companies were not financial firms, but they share key similarities with the large financial firms involved in the 2008 crisis.

For instance, both Enron's and WorldCom's bankruptcies (in 2001 and 2002, respectively) were, at their respective filings, the largest corporate failures in U.S. history. Enron was the nation's seventh-largest company (by revenue) when it filed, and many predicted that its bankruptcy would be calamitous because its creditors included many of the world's major financial institutions.[3] WorldCom's bankruptcy dwarfed the Enron filing; the company operated "the world's largest Internet network" and employed approximately 60,000 people.[4]

These companies were certainly large and interconnected, they were not bailed out, and yet their bankruptcies did not cause worldwide crises. In fact, given the problems at these companies, it is difficult to argue that the economy would have been better off had they been bailed out. The lack of a major crisis following these bankruptcies certainly does not prove that other failures could not have resulted in more economic damage.

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Nonetheless, this problem calls for a rational analysis that was largely absent during the 2008 crisis. Instead, the Treasury Department's Troubled Asset Relief Program (TARP) morphed into a $700 billion general purpose bailout fund, and many firms were forced to take money even though they were financially stable.[5] The extent of economic damage TARP prevented is debatable, but it is clear that TARP solidified the expectation of future taxpayer-funded bailouts.

Bank Tax Enshrines TBTF. Taxpayers should be pleased that the Ways and Means Committee is soliciting comments on a proposal for its Tax Reform Act of 2014, particularly with respect to the plan's bank tax. The draft does not purport to *end* TBTF as much as it claims to *pay* for TBTF, and that is a problem that needs to be fixed. The proposal effectively makes TBTF an explicit policy and assumes that the new tax will pay for future bailouts as if taxes just shuffle money around with no economic consequences.

The so-called bank tax is a 0.035 percent (of total assets) quarterly charge on a subset of large financial firms—those with assets of more than $500 billion—commonly referred to as systemically important financial institutions (SIFIs). This policy seems to employ a rather twisted logic: Congress would take more money away from a small group of companies because Congress cannot stop sending tax dollars to those companies. This gives new meaning to the term tax-and-spend, and it is worse than usual, for several reasons.

First, the tax is purely bad policy. The general idea behind tax reform is to *eliminate* special taxes and tax breaks, not add them to the tax code. The policy also exposes a core flaw in the tax-and-spend philosophy because it pretends that there is no cost to raising taxes and/or that taxes are not ultimately paid for by customers. This arbitrary tax—projected to sap close to $100 billion out of the economy over the next 10 years—effectively acts as a higher capital requirement for certain banks, but the government takes the money to spend on whatever it wants.

Perhaps worse than any of these other reasons, the tax would magnify Dodd–Frank's impact on TBTF because it would reinforce the notion that funneling taxpayer money to companies is necessary. Further, the policy ignores one of the biggest problems with TBTF: It reduces the risk managers have to consider when conducting their business.

What Congress Should Do. Congress should not enact this bank tax and should do the following:

- Institute tax reforms that do not single out individual companies or sectors for special taxes or tax breaks.
- Provide structural changes (such as bankruptcy reform) that make future government bailouts less likely.
- Eliminate Dodd–Frank's Financial Stability Oversight Council and stop all government agencies from identifying SIFIs: Doing so only preidentifies firms considered too big to fail.
- Prevent the Federal Reserve from lending to nonbanks and restore its original role as a lender of last resort to member banks.

1. See Drew Sandholm, "U.S. Still Faces 'Too Big to Fail': Fed's Gary Stern," CNBC.com, January 6, 2014, http://www.cnbc.com/id/101314108 (accessed March 11, 2014).
2. See Al Lewis, "Fraud, Failure and Bankruptcy Pay Well for CEOs," MarketWatch, August 28, 2013, http://www.marketwatch.com/story/fraud-failure-and-bankruptcy-pay-well-for-ceos-2013-08-28 (accessed March 5, 2014). For a different view of the Lehman failure, see Norbert J. Michel, "Lehman Brothers Bankruptcy and the Financial Crisis: Lessons Learned," Heritage Foundation *Issue Brief* No. 4044, September 12, 2013, http://www.heritage.org/research/reports/2013/09/lehman-brothers-bankruptcy-and-the-financial-crisis-lessons-learned?ac=1#_ftn1.
3. See Richard A. Oppel Jr. and Andrew Ross Sorkin, "Enron's Collapse: The Overview; Enron Corp. Files Largest U.S. Claim for Bankruptcy," *The New York Times*, December 3, 2001, http://www.nytimes.com/2001/12/03/business/enron-s-collapse-the-overview-enron-corp-files-largest-us-claim-for-bankruptcy.html (accessed March 10, 2014).
4. Luisa Beltran, "WorldCom Files Largest Bankruptcy Ever," CNNMoney, July 22, 2002, http://money.cnn.com/2002/07/19/news/worldcom_bankruptcy/ (accessed March 10, 2014).
5. See Conn Carroll, "Morning Bell: Paulson's Part of the Problem," The Heritage Foundation, The Foundry, November 18, 2008, http://blog.heritage.org/2008/11/18/morning-bell-paulsons-part-of-the-problem/.

Incentivizing Risk. When managers have no reason to think that their companies will be allowed to fail, they have every incentive to take riskier strategies. Thus, bailouts can actually lead to even more financial risk in the future.

Socializing these costs while potential profits remain private will always end badly. The fact that this proposal socializes costs by singling out a small group of companies for a punitive tax makes even less sense. Moreover, this policy completely ignores the benefits of bankruptcy, thus perpetuating (potentially) unsustainable economic activity.

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