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THE IMPACT OF TAXATION ON FINANCIAL SERVICES

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for

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Introduction:

We plan to look at taxation on the financial sector and comment on the effects it has had on the incentives to diversify savings portfolios. Determining the net effect of taxes on the incentive to save is difficult, particularly when the system treats some forms of savings preferentially. We shall therefore examine the changing nature of funding for banking institutions and how this relates to their market share and product innovation.

Economics of Savings:

The nature of the savings market is determined by the relative contribution of economic agents in terms of current and future consumption. The participation of the different sectors, personal, corporate and government, will effect the overall balance of savings and investment within the economy. Generally, the personal sector foregoes current consumption, thus creating a surplus fund of resources for distribution between the other two sectors. Government sector consumption and expenditure is partly financed by the available personal sector savings. When this proves insufficient the government turns to the external savings market. The Irish experience in more recent decades is that the personal sector is a net saver, while the government is a net borrower (T. O'Connell).

Government policy can affect the allocation of the economy's resources. Taxation is used as a means of redistributing funds between different sectors. By this we simply mean that the government can influence where and how people save. If deposit interest is taxed then the rational saver will find an alternative method of saving for retirement or uncertainty. She might decide to invest with a pension fund which offers more favorable rates of return at lower tax costs. What will happen if the pension fund, in which our rational individual has redirected her savings, decides to diversify its investment portfolio by international diversification? With overseas investment Irish capital investment is not directly benefiting and hence, our economic growth may be affected.

More recent tax policies in relation to Section 84 lending and the Business Expansion Scheme (BES) have alternative implications in terms of resource allocation within the economy. Through these schemes particular industrial sectors benefit from easier access to financing. This is discriminatory in nature and does not necessarily lead to optimal resource allocation. Given that such policies exist the direct and indirect costs/benefits to the overall well being of the economy must be realised.

Taxation of savings affects the allocation of capital, e.g. mortgage interest repayments are deductible and imputed income of owner-occupied housing is not taxed. These provisions give taxpayers the incentive to accumulate their savings in the form of houses rather than as investments that would finance industrial plant or equipment.

Regulation and Implicit Taxation:

When a market, particularly a financial market, is inefficient this cost is borne by society. One of the more detrimental costs in regulating the financial market is that there could be a loss in possible growth, i.e. banks are required to adhere to strict reserve ratios in order to minimise the risk of default. Many institutions while required to hold reserve ratios are also legally bound to maintain capital requirements which deflect capital utilisation from its most efficient use. This can have a distortionary effect in that it prevents the financial market from reaching an efficient equilibrium. Regulation imposes other costs on the industry, for example, optimal portfolio choice is distorted in that the banks are prevented from changing their balance sheet to suit with changing market conditions. The customer suffers via lower interest rates on savings and higher lending rates. This has an inequitable impact on both borrowers and lenders and basically erodes the competitive edge of high ratio banks in relation to low. This is one of the possible reasons for disintermediation. In order to attain a more efficient and equitable financial environment the costs of regulation need to be reduced. Extensive regulation is not necessary. This case has been proved by the recent bank failures and defaults in the more heavily regulated US financial market.

Since Ireland's entry into the EMS there have been changes in the savings market in response to fiscal and regulatory policies which have, in effect, distorted the competition within the financial services industry. For example, the effects of a change in the tax code on the structure of financial transactions in the economy has led to changing shares of different financial institutions.

The imposition of primary and secondary reserve ratios for the associated banks is an implicit tax. The secondary ratio channels funds directly to the exchequer. This in effect gives the government an unfair borrowing advantage over the private sector because the government is able to attain lower interest rates thereby imposing another implicit tax on the banks. The Bank Levy similarly directs resources back to the government sector. These ratios and tax effects are not evenly applied across all deposit taking institutions (e.g. Building Societies) thus distorting the pricing of financial services between banks and non-banks.

Distortions in the Savings Market:

The pattern of savings in Ireland is distorted by the application of differential tax treatment of financial assets. This differential treatment gives tax concessions to some savers, thus creating an incentive to find a method(s) of investment which will produce the highest yield at the lowest cost possible (least taxable).

Another important distortion in the savings market has been the notion of fiscal privilege, defined as the difference between the savers' marginal tax rate and the effective rate of tax levied on an asset's real return. The degree of fiscal privilege may vary across individuals who are subject to different marginal tax rates. This indicates the extent to which the tax system is arbitrary. Fiscal privilege enables us to contrast the way in which the tax system encourages standard and higher rate tax payers to accumulate wealth (R. Thom, 1988). These effects can be seen throughout the savings market, for example, the tax implication of holding funds in a pension scheme means that up

to 15% of the saver's salary that goes into the pension fund is tax free, along with income from the pension fund and lump sum payments upon retirement. There are other forms available, i.e. tax deductability of life assurance premiums is currently 25%. The life assurance companies pay corporation tax on investment profits at 35% which are not then taxable at the investor's marginal tax rate which could be higher. This encourages the growth of indirect investment holdings.

Other forms of fiscal privilege available are: 1) the tax deductability of mortgage interest repayments (i.e., 80% of interest up to max of £2000 per person), this could lead to capitalisation effects, in that the tax benefit of mortgage interest relief leads to an increase in the price of housing (see R. Thom), 2) government bonds and equities which if held directly incur capital gains and income tax (£2000 allowance), and 3) the availability of tax concessions on investments up to £25,000 under the Business Expansion Scheme which tends to benefit wealthier individuals. Clearly we can see that the beneficiaries are those at the high marginal tax bands. The rational saver is motivated to invest in financial assets subject to optimising her use of all available tax breaks.

Deposit Interest Retention Tax:

DIRT was introduced in the 1986 Finance Act and required all deposit taking financial institutions to deduct tax from interest paid or credited with no initial exemption at the standard tax rate. However, some small groups who are not liable for tax are entitled to full refunds. DIRT did not affect the marginal tax liability for bank deposits but savers became sensitive to this immediate deduction from interest earnings, especially those who did not file tax returns honestly. Its introduction may, in part, be responsible for the decline in the banks share of new savings. DIRT has undermined the ability of banks and building societies to effectively compete for personal savings due to misinformation and investor behaviour.

Did DIRT level the playing field between various financial institutions? With its initial introduction in 1986 all licensed

banks suffered a decline in their deposit base from 55% to 47% of total funding that year. The associated banks experienced a fall from 60% to 51% in deposit holdings. Though DIRT did have an immediate impact on the banks, it affected the building societies in a different respect: their expansion in the savings market fell and has remained at a fairly constant level since. During the period 1985-1989 bank funds had grown at a rate of 12% while the building societies lagged behind with a growth rate of 9%. The building societies effective tax rate increased due to the standard rate exceeding the composite rate. Central bank reports prior to 1985 show that the building societies growth was moving along at a faster rate. With the implementation of DIRT and the loosening of regulatory controls there is now little distinction between the roles played by the major deposit taking institutions.

Savings in the government bond market experienced rapid growth between 1985 to 1987 by £4 billion due to their comparative advantage relative to other forms of savings. (from £8.5 billion to £10.8 billion in 1986 to £12.5 billion in 1987) This can be explained either by an increasing need for government funding or, from the savings market perspective, it reflects the rising levels of disintermediation partly motivated by the desire on the part of savers to avoid DIRT in the deposit market. The majority of investors in government savings are those subject to income tax at the highest marginal tax rate.

Composition of the Savings Market:

Investors' behaviour in exercising their preference for financial assets strongly influences the nature of available funds for banks. Changing investor preferences are directly reflected in the composition of bank deposits. The liability structure of banking institutions mainly comprises current account deposits, demand deposits, time deposits, interbank borrowings and shareholders' capital. Their sensitivity to changes in taxation policy, rewards on investment, bank profitability and the availability of alternative investment vehicles are of concern to financial intermediaries whose growth and performance is strongly influenced by their ability to attract new savings. It

is in this context that banking institutions seek deposits; competing life assurance companies attract premium income and pension funds compete for resources. An integrated financial services company must understand the dynamics of these alternative investments in deciding on the structure of its overall business and product portfolios.

The Changing Fund Structure:

The banks' liability structure determines its overall cost of funds. Each component of the funding portfolio carries a different cost. A banking institution will attempt to maximize its scarce source of cheap funds, i.e. interest free current accounts and personal deposit accounts. This has led to an increased dependence on more expensive sources of funding, in particular, large corporate and interbank deposit holdings. In order to attract equity investment, banks must offer dividend and capital growth returns which are competitive with alternative investments, e.g. yields on government bonds.

Table A (all tables are in the appendix) highlights the relative decline in deposit holdings from 55% in 1985 to 42% in 1989 and the increased growth in interbank borrowings from 19% to 28%. The deposit growth rate was low at 4% compared to a 23% growth rate in the interbank borrowings. Table B shows the banks growing dependence on international funds to finance their domestic business. Non-resident interbank liabilities have risen from £2.15 billion in 1985 to more than £5 billion in 1989. Non-resident assets are £3 million lower than non-resident liabilities. As banks diversify their funding towards higher yielding sources the balance sheet becomes more sensitive to interest rate risk. An increased dependence on foreign sources brings about greater sensitivity to foreign exchange risks. Such treasury risks call for the development of structured treasury risk management systems aimed at improved treasury and balance sheet management.

A separate examination on the liability structures of the associated banks, the non-associated banks, and the building societies highlight their relative performance in the deposit and

interbank markets. With regard to the associated banks, Tables C and D outline the relative stability of the resident current account market which has grown at a compound rate of 11% reflecting their involvement in the money transmission business. While current accounts are a cheap source of funds, the transmission function entails high levels of non-interest expense such as staff, information technology, etc., which erode this benefit.

From these tables we can see the relative decline in non-government deposits from 60% in 1985 to 44% in 1989 and a subsequent increase in interbank borrowings from 4% to 19%. As major players in the competitive interbank market the two main banks contribute to liquidity, an important factor in determining the pricing and operational efficiency of this market.

As one would expect the non associated banks are highly dependent on the interbank markets, see Tables E and F. Over 50% of all funding is sourced in these markets. The non associated banks have suffered a reduction in deposits between 1985 and 1989 from 49% to 38% in the domestic market and from 44% to 31% in the non-resident market. This in part may reflect their promotion of a commercial paper market where corporates substitute commercial paper for deposit holdings. This type of disintermediation is motivated by the desire of companies to avoid DIRT. Banks benefit from this inevitable switch by attracting fee based income in matching buyers and sellers of commercial paper. This presents an opportunity to diversify income sources.

The Growth of Non-Banks:

Life assurance companies and pension funds now command the largest share of the savings market (see table G). As such these institutions are important sources of competition for traditional financial intermediaries. The increased market share of life assurance and pension funds is partly a result of the process of disintermediation whereby investors in search of more tax efficient returns avail of the benefits offered by these institutions. It is important to note that the placing of investor funds in a life assurance policy or pension fund is a

longer term commitment which diverts more stable funds towards these institutions. This implies that bank funding maturity may become more short term, thereby worsening the mismatch between liability and asset maturities. This introduces further risk and uncertainty into bank balance sheets.

In the period from January 1985 to December 1988 the premium amount of £778 million was paid into life assurance companies. The change in domestic non-government deposits over the same time amounted to £280 million reflecting a preference on the part of investors for more tax efficient life products. Total life assurance assets amount to about £6 billion of which approximately £3 billion is held in domestic bonds.

Pension fund assets are of the order of £7 billion of which approximately £2.5 billion is held in domestic bonds while over £1.2 billion is invested abroad. Both pension fund and life assurance companies have become important sources of funding for the government. The positive tax discrimination of their financial assets has resulted in the availability of further funds for the exchequer.

Non-banking institutions have become a powerful force in the savings market, e.g. pension funds have become one of the largest sources of savings in this country in the past few years. Strong competition for savings has had an important impact on the changing nature of available funds for banks. Ideally, the associated increased cost of funds would be reflected in higher interest rates chargeable on their lending business. A real difficulty is that the lending market is very competitive and opportunities for securitisation and disintermediation also exist. Therefore, the increased cost of funds cannot realistically be passed on to borrowers. This results in reduced margins on traditional banking activities with related implications for bank profitability and performance.

Reflections:

- * Innovation is an important prospect in any industry, but why have we not seen it play a more active role in the financial sector in the past? There are a number of reasons as to why this might be the case, e.g., there's a lack of protection for financial innovation which means that the entrepreneurial bank's advantage is undermined by a short product cycle -- other banks would follow suit and the innovator would not receive just rewards. The lack of consumer demand until recently is also another plausible explanation along with the notion of government regulation, exchange controls.

- * In an era of changing saving preferences, financial institutions share must develop products which allow their customers to benefit from differential tax policies. Those financial institutions which fail to adopt their product portfolios in the face of a changing demand will lose market share.

- * As regards institutional regulatory constraints in which banks currently operate, the development of products which bypass onerous capital requirements such as commercial paper, will result in increased market share e.g., participation in the processes of disintermediation and securitisation.

- * The savings market has experienced a shift in the flow of funds between the deposit market and other savings instruments. Our paper has illustrated this shift in the context of taxation and regulatory influences. Changes in the financial market will continue to influence future growth for firms within this industry.

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APPENDIX

TABLE A.

ALL LICENCED BANKS

AGGREGATE LIABILITY STRUCTURE vis-a-vis RESIDENTS

	1985	1989	Compound Growth Rate
TOTAL LIABILITIES	12,013 (100%)	18,632 (100%)	12%
NON GOVERNMENT DEP.			
CURRENT	1,069 (9%)	1,621 (9%)	11%
DEPOSIT	6,607 (55%)	7,788 (42%)	4%
INTERBANK BORROWINGS	2,258 (19%)	5,123 (28%)	23%
CAPITAL	868 (7%)	1,421 (8%)	13%
OTHER (incl. Borrowings from C.B.)	1,213 (10%)	2,683 (14%)	22%

	1985	1989	
TOTAL ASSETS	15,233	22,216	



TABLE B

ALL LICENCED BANKS

AGGREGATE LIABILITY STRUCTURE vis-a-vis NON-RESIDENTS

	1985	£ M	1989	Compound Growth Rate
TOTAL LIABILITIES	5,984	(100%)	9,939	(100%) 14%
CURRENT & DEPOSIT ACCOUNTS	2,693	(45%)	2,783	(28%) 1%
INTERBANK	2,154	(36%)	5,069	(51%) 24%
CAPITAL	1,525		808	

	1985		1989	
TOTAL ASSETS	2,622		6,356	

TABLE C.

ASSOCIATED BANKS

LIABILITY STRUCTURE vis-a-vis RESIDENTS

	1985	£ M	1989	Compound Growth Rate
TOTAL LIABILITIES	6,928	(100%)	11,572 (100%)	14%
NON GOVERNMENT DEP.				
CURRENT	1,018	(15%)	1,528 (13%)	11%
DEPOSIT	4,157	(60%)	5,115 (44%)	5%
INTERBANK BORROWINGS	305	(4%)	2,164 (19%)	63%
CAPITAL	663	(10%)	1,014 (9%)	11%
OTHER (incl. Borrowings from C.B.)	790	(11%)	1,724 (15%)	21%

	1985		1989	
TOTAL ASSETS	8,837		12,900	

TABLE D.

ASSOCIATED BANKS

LIABILITY STRUCTURE vis-a-vis NON-RESIDENTS

	1985	£ M	1989	Compound Growth Rate
TOTAL LIABILITIES	3,011	(100%)	4,803 (100%)	12%
CURRENT & DEPOSIT ACCOUNTS	1,355	(45%)	1,153 (24%)	-4%
INTERBANK	807	(27%)	1,873 (39%)	23%
CAPITAL	562		1,285	

	1985		1989	
TOTAL ASSETS	1,102		3,475	

TABLE E.

NON ASSOCIATED BANKS

LIABILITY STRUCTURE vis-a-vis RESIDENTS

	1985	£ M	1989	Compound Growth Rate	
TOTAL LIABILITIES	5,084	(100%)	7,060	(100%)	9%
NON GOVERNMENT DEP.					
CURRENT	46	(1%)	92	(1%)	19%
DEPOSIT	2,491	(49%)	2,683	(38%)	2%
INTERBANK BORROWINGS	1,982	(39%)	2,965	(42%)	11%
CAPITAL	216	(4%)	400	(6%)	17%
OTHER (incl. Borrowing from C.B.)	351	(7%)	924	(13%)	27%

	1985		1989		
TOTAL ASSETS	6,737		9,315		

TABLE F.

NON ASSOCIATED BANKS

LIABILITY STRUCTURE vis-a-vis NON-RESIDENTS

	1985	£ M	1989	Compound Growth Rate
TOTAL LIABILITIES	2,973	(100%)	5,136 (100%)	15%
CURRENT & DEPOSIT ACCOUNTS	1,308	(44%)	1,612 (31%)	5%
INTERBANK	1,397	(47%)	3,179 (62%)	23%
CAPITAL	196		284	

	1985		1989	
TOTAL ASSETS	1,617		2,880	

TABLE G

RELATIVE SIZE OF

FUND PORTFOLIOS

£ M

1985

1989

TOTAL BANK LIABILITIES	17,997	28,571
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TOTAL NON GOVMT.		
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DEPOSITS	10,369	12,192
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(CURRENT & DEPOSIT)		
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BUILDING SOCIETIES SHARE DEPOSITS	2,616	3,632
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LIFE ASSURANCE (ASSETS)	3,000	6,500
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PENSION FUND (ASSETS)	3,500	7,000
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