Pigouvian Taxes: A Primer for Financial Policy

Comments on John Cochrane's presentation
Panel on "Taxing Leverage in the Financial Sector"
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How Do Markets & Policies Fail?

- Externalities
- Moral hazard
- Adverse selection
- Rent seeking
- Internalities
- Policy side effects

All exist in the financial sector. Elsewhere in the economy, all have been addressed through taxes.

How Can We Address Externalities?

- Liability
- Direct regulation
  - Specify business practices
  - Establish performance standards
- Market-based regulation
  - Set a price (Pigouvian tax)
  - Set a quantity (cap-and-trade)

Direct regulation has been the focus of prudential financial policy.

When Do Pigouvian Taxes Work Well?

- Optimal for some activity to occur
- Activity creates similar external costs OR tax can be calibrated to external costs
- Wrong price is less costly than wrong quantity
- Redistribution from tax is acceptable

If externalities from leverage are like …

- Lead in gasoline, for which the optimal amount is zero, we should ban leverage, not tax it
- A fish stock, for which we can identify a safe level, we should regulate its level, not tax it
- Carbon emissions, for which we want firms to balance costs and benefits, we should tax it

What Political Concerns Do Taxes Pose?

- The “T” word vs. the “F” word
  - Taxes and fees sound different politically
  - Congress levies taxes, not flexible
  - Agencies collect fees, may be flexible
- Taxes <u>or</u> regulation vs. taxes <u>and</u> regulation
- Using the revenue
- Taxing sin & sinners

THANK YOU

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