Pigouvian Taxes: A Primer for Financial Policy

Comments on John Cochrane’s presentation
Panel on “Taxing Leverage in the Financial Sector”
The Second Symposium on Ending Too Big Too Fail
Federal Reserve Bank of Minneapolis

May 16, 2016

Donald B. Marron
Director of economic policy initiatives, Urban Institute
How Do Markets & Policies Fail?

- Externalities
- Rent seeking
- Moral hazard
- Internalities
- Adverse selection
- 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 or regulation vs. taxes and regulation
- Using the revenue
- Taxing sin & sinners
THANK YOU

For more information please contact:

Donald B. Marron
dmarron@urban.org

Find many studies on tax policy at
www.taxpolicycenter.org