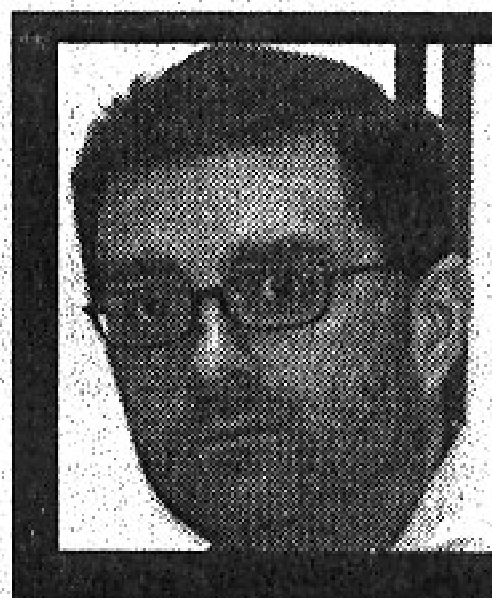
Commentary

Neither a lender nor a borrower be



The Acevedo Vilá administration has recently introduced a bill (HR 1579) to impose an additional temporary tax of 4 percent on corporations and partnerships that provide financial services in Puerto Rico.

In our view, the proponents of the tax have ignored a basic tenet of economics, namely, that people, including corporations, respond to incentives. Almost every conceivable tax affects the decisions of individuals and firms, often leading them to undertake actions they would not otherwise have taken, just to avoid paying taxes. This kind of behavior is socially unproductive because its only consequence is to reduce the tax burden of a single individual or corporation, without yielding anything useful. In addition, tax avoidance behavior uses up resources that could have been allocated to other more productive endeavors.

In general, if the sole objective of a tax is to raise revenues, as is the case with the special tax on financial institutions, then it would be preferable to impose the kind of tax that generates the lowest possible total excess burden. For a number of reasons, the special tax on financial institutions does not satisfy this test.

First, the special tax will be imposed on the net interest income of financial institutions. Net interest income, basically interest income minus interest expenses, is a measure of the efficiency of a financial institution in the conduct of its core business, which is buying money at a low price and lending at a higher price. Net income, on the other hand, takes into account non-interest income and expenses, such as income from service fees and trading account losses, as well as operating expenses.

Therefore, imposing a special tax on net interest income will provide incentives for financial institutions to modify how they conduct their core lending operations in order to lower or shift the expected tax liability and to increase their non-interest income, which is not subject to the special tax. In other words, we can expect financial institutions to undertake actions they would not otherwise have taken, just to avoid paying this special tax.

To bring this picture into clearer focus, we have analyzed the audited consolidated statements of income of Popular, Inc., the largest local financial services company, for the year ended Dec. 31, 2004. As of that date, Popular reported interest income of $2.2 billion and interest expense of $840 million, for a net interest income of approximately $1.4 billion. Popular's bottom line net income for the same period, on the other hand, was $489 million.

Thus, it is obvious why the Treasury Department prefers to impose the special tax on the net interest income of financial institutions and not on their net income: 4 percent of $489 million equals $19.5 million, while 4 percent of $1.4 billion equals $56 million. A windfall to Treasury of $36.5 million.

Treasury, however, is ignoring the fact that financial institutions will change the way they conduct their business in order to shift at least some of the new tax burden to their clients. To understand how banks will do this we have to dig a little deeper into their income statements.

Following up our analysis of Popular, we notice that it reported interest income from four segments: (1) loans, (2) money market investments, (3) investment securities and (4) trading securities. Of these four elements, only the interest charged by Popular on its loans is subject to its control; the income it receives on the other three components depends on market conditions.

On the expense side, Popular reported interest expenses in connection with (1) deposits, (2) short-term borrowings and (3) long-term debt. Again, of these three elements only the interest paid to Popular's depositors is subject to its control; the interest it pays on its own borrowings is determined by conditions in the capital markets and Popular's own credit and risk profile. Therefore, we can expect Popular to respond to the special tax by increasing the rates it charges on its loans, reducing the rates it pays to depositors or, most probably, doing a little bit of both.

Under normal market circumstances, there would be a limit to how much banks could either raise their lending rates or reduce the rates paid on deposits. However, in this instance market forces will not work because the government has changed the incentive structure in the market so that all financial service institutions have incentives to do exactly the same thing.

Furthermore, it is unlikely that Treasury will raise all the revenue it expects to raise from this tax. Section 1(d) of the proposed bill excludes from the calculation of net interest income all interest received from obligations issued by the U.S. or Puerto Rico government. This exclusion provides a strong incentive for banks to use a significant portion of the money they would otherwise lend, the interest on which would be subject to the percent tax, to purchase U.S. and Puerto Rico bonds, the interest on which would not be subject to the special tax. Thus, the proposed bill induces banks to finance deficits incurred by spendthrift politicians in Washington and San Juan, while discouraging lending to the productive sector of the economy.

Finally, the special tax provides incentives for banks to increase their non-interest income because such income would not be subject to the special tax. Service fees are the largest component of non-interest income for most banks. For example, Popular generated approximately $460 million from various service charges and fees in 2004. It should not be surprising if financial institutions try to shift some of the 4 percent tax burden to their clients in the form of higher service fees.

In summary, the additional tax distorts the local financial market, provides incentives for banks to increase rates on loans and decrease them on deposits, and encourages banks to expand their passive investment portfolios and increase service fees.

Therefore, we can expect the excess burden generated by this tax to be quite significant. In addition, it is highly unlikely that the tax will generate the amount of revenue expected by Treasury. Thus, we may end up with a tax that distorts the financial market and that raises little revenue. Bad days indeed for both affluent lenders and borrowers in need.

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