

The case for taxing interest¹

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Abstract

The focus of this paper is Western economies (the West), primarily represented by the European Union and N. America, using the US – the largest Western economy – for illustrative purposes where appropriate. It notes the failure of past attempts, using a variety of measures, to prevent banking crises from reoccurring and to improve banking survivability. Regrettably, the economic literature has not classified interest bearing debt – the primary source of financial breakdowns – as a negative externality, despite potentially representing the largest and growing negative externality plaguing Western economies. Thus, the paper investigates this cancerous negative externality and its effect on cyclical, households, corporations, economic uncertainty, national defense, and democracy. It ascribes the growth of the debt phenomenon to a biased tax system that favors debt over equity finance. It explains the rationale of imposing Pigovian (excise) taxes on demerit goods such as alcohol to curb their consumption and argues in favor of imposing a similar tax on interest bearing debt to restrict its use. It concludes with a brief discussion of the likely effects of such a tax on the economy, forms of financing, the structure of banking, and monetary policy. The paper uses qualitative analysis to arrive at its conclusions.

Keywords bank, debt, equity, externality, interest, tax

Introduction

This Time Is Different (Reinhart and Rogoff, 2009) is a fascinating book; it examines debt crises from as far back as 1258, reporting on a shocking frequency of financial fiascos worldwide: 268 crises between 1800 and 2008. Surprisingly, advanced economies – despite enjoying more advanced planning, better discipline, and greater financial sophistication – have suffered deeper crises, affecting more countries, and with greater frequency than developing countries, sustaining 19 banking crises since World War II. One plausible explanation is that the banking sector is more deeply entrenched in advanced economies and more tightly integrated into the legal, political, and economic fabric, particularly, the tax framework, facilitating more indebtedness relative to GDP and, consequently, deeper and more frequent financial breakdowns. Most illuminating is the book's ironic title, *This Time Is Different*, hinting that we presume every crisis is different instead of endless replays of variations on essentially the same theme.

Piles of books have been written on banking crises. *The Problem with Banks* (Rethel and Sinclair, 2012), coming on the heels of the global financial crisis, is a fitting example. It is an exposé of banks' chronic problems, requiring colossal support from the US government and the Federal Reserve to survive. A review of the book in *Economic Record* journal (Perumal 2016) accepts the book's conclusions that banks are "troublesome institutions"; however, it finds most of the material reiterates descriptions of the problems facing the banks without offering real solutions, the reforms proposed at the end of the book being brief and lacking in

¹ This paper entails no conflict of interest and the author has no business links with the industry concerned. It elaborates on and extends the analysis and concepts presented by the author in *Two Centuries of Parasitic Economics* (Al-Nakeeb, 2016).

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detail. Perhaps those scholars did not offer a comprehensive solution because so many of their peers have previously tried and failed.

Despite an abundance of solutions – proposed by celebrated scholars, governments, central banks, and international organizations – bank failures and crises have continued unabated. Typically, the solutions consist of tinkering, at the margin, with the banking model, its regulations, and policies, but without stepping outside the flawed banking box. The most ambitious and concerted international initiative to improve banking survivability and solvency has been the establishment in 1975 – in the wake of the 1974 crisis – of the prestigious Basel Committee on Banking Supervision (Basel), under the direction of the governors of the central banks of the ten largest economies. Its mandate states:

The Basel Committee on Banking Supervision (BCBS) is the primary global standard setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability (Basel Committee on Banking Supervision).

So far, it has released three sets of banking guidelines and regulations: Basel I, Basel II, and, most recently, Basel III, in 2010-2011 – in the wake of the 2008 global financial crisis. By not succeeding in preventing bank failures and crises, those periodic Basel pronouncements have been, in reality, a series of illusions of solutions, which have kept hope alive that banking can yet be fixed. BCBS has been in a unique position to lead the indispensable structural reform that banking desperately needs, by declaring the present model defunct and proposing an alternative one. Instead, it has settled for the easier task of prolonging the demise of banking as we know it and with it the attendant crises that the world must endure, propagating a forlorn hope that next time is different – a grand disservice to the world and the banks it had set out to serve.

There is a dearth of effective ideas because banking does not take well to solutions that infringe on its sacrosanct banking box. Indeed, even lesser measures are not tolerated. Thus, in the aftermath of the Great Recession, Iceland's actions were condemned for allowing its failing banks to fail while the Greek government was showered with praise for following the instructions of its creditors. Today, Iceland's once sickly economy is healthy and vibrant while the Greek economy continues to linger in depression. Despite ample proof of what worked and what did not from the perspective of the citizens of those countries, there has been no formal international admission of reality and no retraction of any condemnation or praise.

Albert Einstein – a widely recognized genius – famously warned, “We cannot solve our problems with the same thinking we used when we created them.” He also described futile repetitive behavior as: “Insanity: doing the same thing over and over again and expecting different results.” It is most unwise to take Einstein's advice lightly; finding a durable solution to the banks' periodic and deepening calamities requires the intellectual courage to admit that past thinking has been amply and repeatedly demonstrated to be wrong and fruitless, making a fresh look from a different angle inescapable and absolutely necessary.

1. The negative externality of interest bearing debt

A positive externality arises when the public (social) benefit from consuming a good (service) exceeds its private benefit, a spillover effect where additional benefits accrue to third parties who are not party to the transaction. Education is an often-cited example of a positive externality because besides benefiting the students concerned, it also benefits society as a whole.³ By contrast, a negative externality arises when a transaction causes a negative spillover that affects third parties who are not party to the transaction, thereby raising the public cost of a good over and above its market price. Environmental pollution is a prime example of a negative externality, having a near-zero private cost to polluters and a large public cost to society.⁴

Doubtless, the full cost of debt is greatly underestimated, considering it may well be the largest negative externality facing advanced economies. For example, many borrowers unwittingly presume that nominal interest is the cost of debt,⁵ until they default. Similarly, to the extent that indebtedness amplifies cyclicalities it magnifies another negative externality because recessions entail enormous social costs such as loss of jobs, profits, increases in governmental outlays, and reductions in government revenue.⁶

Still, the following hardly attempts to quantify the full cost of interest bearing debt, but only the more modest endeavor of identifying some of its implicit incremental costs through its impact on cyclicalities, households, corporations, etc.⁷

1.1 Cycle amplification

The best-publicized contractions during the past hundred years were all debt related, frequently accentuated by misguided monetary policy during the expansion, contraction or both, including the Great Depression, the twin Volker recessions in the early 1980s, the Internet bubble in 2000, and the global financial crisis in 2008. Thus, at a minimum, credit tends to amplify the business cycle, on the upside and downside.

Irving Fisher (1867-1947) was a neoclassical economist, but the Great Depression convinced him that debt creation induces economic expansion and fuels speculative asset bubbles, while credit contraction bursts them, followed by recession or depression. Sadly, his seminal

³ Societal benefits of education include contributing to upgrading the skills of its work force, raising their standard of living, improving their employment prospects, reducing the need for income support, and increasing tax revenue. It also nurtures successful entrepreneurs that provide employment opportunities, develop new industries, and spur economic growth. Furthermore, a better educated society tends to enjoy a better quality of life and higher standards of living, makes better political and economic decisions, and suffers less crime. These positive spillover effects accruing to society makes education a merit good because, in addition to its private benefits, it has large public benefits; hence, pricing education based on its private benefits alone would result in less than optimal level of consumption from society's perspective, calling for public encouragement of education by subsidizing it or offering it free.

⁴ More specifically, air, water, and soil pollution damage public health, increase medical bills, and harm buildings, forests, crops, fish, and animal herds. Hence, responsible governments enact laws, regulations, and impose penalties to protect the environment from all forms of pollution. In addition, governments impose taxes to restrict the magnitude of negative externalities.

⁵ In what follows the negative externality of interest, interest bearing debt, and debt are used interchangeably to mean the same thing.

⁶ For a thorough discussion of the negative externality of recessions, see Al-Nakeeb, 2016, "Economic Cycles as Externalities" in Chapter 11.

⁷ Estimating the full cost of interest to Western societies is a huge task, requiring teams of skilled researchers and appropriate funding.

Debt-deflation theory (Fisher, 1933) did not receive the attention it deserved. Alas, Fisher stopped short of proposing a structural solution to curtail the pervasiveness of debt in the economy to dampen economic cycles. Interest in Fisher's theory has revived since the 1980s; post-Keynesian economists Hyman Minsky developed it further (Minsky, 1986), while Steve Keen modeled Minsky's financial instability mathematically (Keen, 1995).

During the expansion phase, optimism permeates the economy, inducing lenders to relax their credit standards, thereby accelerating the pace of expansion and, consequently, bringing forward its premature end. In contrast, during a recession, lenders become cautious and raise their credit standards, making a recession deeper than it would be otherwise. These pro-cyclical credit policies increase the amplitude of cycles. It is economically more efficient and less disruptive to have less violent fluctuations in asset prices (e.g., stocks, bonds, properties), gentler and longer lasting expansions, and shallower and shorter contractions.

The following reiterates and elaborates on certain aspects of how credit amplifies the expansion-contraction cycle:

- Easy credit facilitates excessive business investment during the expansion phase, resulting – during the contraction phase – in greater excess capacity, larger investment cutbacks, heavy indebtedness, and increased business failures.
- Excessive expansion of housing credit fuels higher house prices, attracting speculative demand that spurs housing construction and expands employment and consumption. Ultimately, an excessive housing inventory develops, causing house prices to drop followed by a contraction in housing credit and construction. The contraction spreads to the rest of the economy, causing the newly unemployed to default on their mortgages and the banks to repossess and sell their homes, crashing house prices and bringing new construction to a near halt, followed by another round of defaults. For a while, this self-feeding vicious cycle continues, contributing to a deeper contraction.
- Credit expansion also amplifies the cycle in stock prices. For example, a 50 percent credit margin policy permits the doubling of the size of stock portfolios, lifting stock prices higher in a bull market. Higher stock prices, in turn, increase the equity of stock accounts with brokers, providing more margin borrowing and purchasing power, which feeds the cycle of stock purchases followed by higher stock prices, further boosting margin availability. At some point, the market tops and begins to decline, inducing the cycle to work in reverse, this time as a price-credit contraction spiral. Lower stock prices diminish the market value of stock portfolios, triggering margin maintenance calls, which require investors to provide additional capital or else liquidate stocks to maintain credit margins, pushing prices lower. Thus, borrowing on margin first exaggerates the rise then fall in stock prices.
- Worse still, margin – by fueling leaps in stock prices – rouses a speculative, herd like, behavior in the investing public's psyche; as a result, the investing public's maximum portfolio positions tend to coincide with maximum credit availability near market tops, while their minimum stock positions tend to coincide with minimum credit availability near market bottoms. Record stock turnover around market peaks and bottoms supports this conclusion. The result is the worst investment strategy imaginable, running contrary to the cardinal rule of shrewd investing: buy low and sell high. It also affords astute investors opportunities to significantly increase their own return by acting as counterparties to the

investing public, selling stock to the investing public at high prices then buying it back from them at low prices. More generally, a credit cycle tends to have a similar negative influence on the investment performance of the investing public in other asset classes as well.

- Credit expansion, by inflating asset prices and investors' wealth, also induces incremental consumption due to the so-called wealth effect. When the bubble bursts, debt works in reverse, reducing wealth excessively and, with it, consumption. Thus, the credit cycle amplifies swings in consumption, adding to cyclical fluctuation.
- Monetary authorities have been known to misjudge the state of the economy. Moreover, the measures they take, with rare exceptions, are delayed reactions to economic events. Thus, during an upturn, they initially tend to raise interest rates modestly then raise them too high and – invariably – too late. During a downturn, they tend to delay cutting interest rates, then cut them too little and too late. Both effects amplify cyclical swings.⁸
- National debt can add to cyclicity. During an expansion, national debt facilitates more government spending than is available based on tax revenue alone, thereby exaggerating the expansion. During a recession, the deficit becomes too big, inducing banks to lobby governments to adopt austerity, inducing deeper recessions than otherwise. Thus, after decades of debt-financed overspending, excessive national debts have induced the governments of Greece, Italy, Portugal, Spain, Ireland, Hungary, Britain, France, and other nations to cut their budgets in the depth of contractions. As a result, they are facing widespread unemployment, unrest, deteriorating social services, and larger budget deficits, while their national debts continue to spiral out of control. In addition, heavy indebtedness accentuates the cyclicity in other countries through its effect on international trade.

1.2 Implicit costs to corporations

Aside from making timely interest and principal payments, indebted corporations must meet all the terms and conditions of their indentures at all times to avoid insolvency; these terms include the maintenance of liquidity and solvency ratios and cross-default⁹ and negative pledge clauses.¹⁰ Violating any of these terms risks triggering an event of default and, hence, these constitute incremental financial risks to corporations (especially during recessions). Moreover, violating these terms permits lenders to renegotiate loan conditions to gain greater advantage, yet another tacit cost to corporate borrowers.

Other things being equal, indebted corporations are more likely to fail than those that are debt free; furthermore, the more heavily indebted corporations are – under various measures of indebtedness such as debt to equity, debt to total assets, and so forth – the more likely they are to fail. Moreover, responsible corporations compensate for the financial risk of debt by

⁸ An economy substantially weaned off debt removes the interest handle from monetary authorities, eliminating a prime source of amplified cyclicity by leaving markets to determine rates of return instead of leaving it to a central bank, in effect, a socialist style central planning committee for capital markets in everything but name.

⁹ A cross-default clause makes the default of a borrower on any loan an event of default on the present loan as well, thereby greatly magnifying the financial risk to the borrower.

¹⁰ A negative pledge clause requires a borrower not to pledge any of its assets to a third party, thereby greatly restricting a borrower's room for maneuvering in a financial emergency.

reducing their business risk taking, resulting in slower growth for businesses and the economy.

Worse still, the effect of indebtedness is uneven across corporate sectors, with its negative impact falling most heavily on sectors with a natural tendency for wider cyclical fluctuations, particularly those with high operating leverage like capital-intensive industries. Several vital sectors fall in this category, including the automotive, airline, and steel industries. Even without borrowing, the presence of debt in the economy magnifies cyclical fluctuations for these industries and increases their business risk. Superimposed on this debt environment are monetary policies that can exaggerate cyclicality. Hence, many such companies go under during business downturns. For example, much of the US steel industry in Cleveland, Ohio, evaporated, permanently, in the wake of the 2000 recession; foreign industrialists bought the idle plants at a fraction of their replacement cost, dismantled them, and shipped them overseas, thereby providing fiercer competition to the unfortunate residual US steel producers.

1.3 Implicit costs to households

Defaulting mortgage borrowers suffer bank repossessions of their homes, typically losing their home equities accumulated over many years, an incremental cost that is over and above the nominal interest of the mortgage and a significant implicit cost of interest bearing debt. In addition, the personal traumas associated with defaults are grave. How deep is the pain of homelessness and broken families following mortgage defaults? What are the economic as well as the emotional costs of losing a family business to a bank? Can anyone imagine the desperation of farmers in India driven to suicide because they cannot withstand losing their farms and livelihoods for failing to meet a bank mortgage payment? Suicides also increase with the rise in poverty, which spreads wider as a recession deepens. What is the dollar equivalent of making tens of millions of people desperate and miserable? Those public costs are enormous and real but unaccounted for under current national statistics because present statistical and accounting methods are insufficiently sophisticated to do so, thus, seriously understating the true cost of debt. Fittingly, the original Latin meaning of “mortgage” is death.

1.4 Uncertainty and other economic effects

Keynes: The Return of the Master (Skidelsky, 2010) points to Keynes' analysis that uncertainty increases economic instability, raises the normal rate of unemployment, and slows economic growth.

More generally, we would expect high indebtedness to be associated with (1) greater uncertainty, (2) higher unemployment, (3) a fall in industrial investment, (4) higher interest rates, (5) currency overvaluation, (6) mounting budget and trade deficits, (7) industrial erosion, and (8) slower economic growth. In the case of the US economy, all of the above characteristics have progressively materialized over the past three-and-a-half decades, save high interest rates. US monetary policy has caused wild gyrations in interest rates, peaking at exceptionally high levels in the early 1980s then trending to abnormally low levels in recent years; Fed interventions have thwarted a market-determined interest rate, a serious violation of the conditions necessary for Pareto optimal resource allocation. Given the size of the US economy, its interest rate policy has been mirrored in other Western economies.

1.5 Threat to national security

Admiral Mike Mullen, a former chair of the US Joint Chiefs of Staff, is well qualified to assess threats to national security. In an interview with *Fortune* magazine, he commented on national debt by saying, "It's the single biggest threat to our national security" (*Fortune Magazine*, 2012). Niall Ferguson voiced a similar concern, predicting that by 2019 interest payments on the federal debt could potentially rise to 17 percent of the federal revenue, which would limit US military spending and US international power projection (Ferguson, 2010). Moreover, a significant downgrade of US credit would cause a sudden spike in the cost of federal debt, potentially constraining the financing of national defense.

1.6 Corruption of democracy

Indebtedness is addictive and, like all dependences, it is difficult to rein in. National debt permits nations to live beyond their means in the short to medium term at the price of loss of fiscal discipline, slower economic growth, and lower living standards in the medium term and beyond. In a properly functioning democracy, taxes are the price of public goods. Thus, voting for increased public goods implies accepting higher taxation. When national indebtedness is constitutionally permissible, democracies are prone to become increasingly indebted over time because cunning politicians can entice voters with a seemingly free lunch – increasing public goods without a corresponding increase in taxes.

Politicians who initiate big budget deficits know that biting tax increases must inevitably follow, but they hope they would have departed the political scene by then, leaving it to others to clean the fiscal mess they leave behind. They bequeath to future generations a debt burden, particularly if they used the debt to pay for current expenditures instead of financing long-lived infrastructure that benefits future generations. Taxing future generations without giving them corresponding benefits swindles future taxpayers. It represents an inter-generational inequity because it increases the benefits to and cuts the tax burden of mature citizens today, while increasing the tax without corresponding benefits on the young and yet-to-be-born. Moreover, deferring taxes increases their ultimate amount by the cumulative interest on the portion of national debt that financed the tax shortfall until its full repayment.¹¹ Consequently, national debt, by distorting public choice, undermines the foundations of democracy and sound public policy.

1.7 The escalating cost of debt

The problem of servicing national debts in the West is acute, but it promises to get worse still due to three factors. First, the interest rate has been at record lows, which is unsustainable over long periods; the inevitable rise in the interest rate will radically increase the debt burden. For example, *Forbes* magazine estimated the US federal debt to soon exceed \$20 trillion (*Forbes Magazine*, 2016). Federal Reserve Bank of St. Louise data indicates that on December 29, 2016, the interest rate on a ten-year US Treasury bond was 2.49 percent compared to 6.31 percent twenty years earlier, on December 29, 1996 (Federal Reserve Bank of St. Louise). A return to the higher interest rate environment would dramatically increase the burden of the federal debt to about \$1.3 trillion per year. Second, given the

¹¹ Japan has one of the highest ratios of debt to GDP, but, so far, its consequences have been muted because of Japan's exceptionally low interest rate and because, as a nation, it is a net international creditor.

ongoing large budget deficits and slow economic growth, national debts in the West will continue to rise much faster than the GDP. Third, longevity and an aging population will add to the growing financial burden, particularly if emigration rates fall.

These factors will affect most if not all Western countries. Thus, it is a matter of time before interest payments on Western national debts, without corresponding benefits, become unbearable for taxpayers and politically impossible to sustain. At that point, Western governments must choose from among three alternatives: higher taxes on the ultra-rich, inflation where the bulk of the debt is denominated in a domestic currency, or repudiation of the debt, or some combination of these.

2. Banking as a fiscal phenomenon

Unlike any other business, banking is based, since its inception, on a flawed business model that is prone to periodic bank runs and waves of mass failure. Instead of reconfiguring their business model to resolve this problem, banks have resorted to political pressure to obtain government appropriations in the form of massive treasury bailouts, ultra-cheap central bank funding for extended periods, and otherwise. This massive aid is in fact a thinly veiled public-sector subsidy to a sector that not only does not supply merit goods like the health care and education sectors, but rather supplies harmful demerit goods for which there is no economic justification, any more than subsidizing other producers of demerit goods like tobacco, alcohol, or pollution. Moreover, the size of the subsidies to sustain banking has reached colossus proportions, as the 2008 Great Recession demonstrated, and it will continue to grow as the debt grows, relentlessly.¹² At some point, probably in the not too distant future, the public will reject those exuberant subsidies for the benefit of ultra-rich bank owners; consequently, failing banks will be taken over by the state at considerable loss to the bank owners, as happened in Iceland. Therefore, it is in the interest of bank shareholders to reconfigure their business model while they still can, before events overtake them.

3. Borrowing as a tax phenomenon

The principle of tax neutrality is important for maintaining economic efficiency. In general, taxes should not distort economic behavior by influencing, for example, the choice of financing, unless there is a compelling economic reason to do so. Unfortunately, several taxes violate this principle by providing incentives for using debt instead of equity financing, such as:

1. the corporate income tax
2. the personal income tax

¹² Direct fiscal aid to the banks is not economically the most rational in other respects as well. For example, following the sub-prime crisis in 2008, the Federal government extended some \$700 billion in emergency funds to bailout the big banks instead of the millions of delinquent homeowners; shortly thereafter the lending banks foreclosed on those properties, selling them at deep discounts, crashing the property market, and bringing construction to a dead halt. The moral economic policy was to bailout the delinquent homeowners who would have repaid the banks, thereby bailing out two parties instead of one, stabilizing the housing market, bringing about a faster recovery, saving the banks and the homeowners hefty losses, and avoiding clogging the courts with a tidal wave of court cases to boot.

3. tax-exempt municipal bonds
4. the dividend withholding tax.

Yet, economists have rarely voiced concern about the lack of tax neutrality with respect to interest. For example, the prominent economic scholar Friedrich von Hayek was an avid supporter of Pareto optimality and a keen student of economic cycles, yet he did not criticize the debt bias of the tax system or its role in economic instability. His silence on the subject is particularly puzzling given that he spent a lifetime studying economic cycles and advocating economic efficiency.

A wise saying states, "There are always good reasons for doing the wrong thing." The familiar justification for the corporate income tax interest deductibility is that it is a business expense, the cost of providing capital. However, applying this logic uniformly would require a similar deduction for dividends, the cost of providing equity capital. Such an even-handed treatment would provide neutral taxation that eliminates the tax incentive for corporate indebtedness.

The degree of interest bias of the corporate income tax is directly proportional to its tax rate; the higher the rate, the greater the tax advantage of debt over equity financing. Around the turn of the 20th century the top corporate income tax rate in many industrialized countries was no more than 15 percent. However, the enormous costs of two world wars compelled many Western countries to raise their corporate income tax rate to 50 percent or higher, making the after-tax cost of equity financing punitive, while the tax deductibility of interest provided an extraordinary tax advantage for debt financing. Many corporations adapted to the higher tax rate by increasing their use of debt to partially recover their previously higher after-tax rates of return on equity.

At a minimum, tax neutrality requires comparable treatment of interest and dividends. However, tax neutrality between equity and debt financing is not an economically sensible policy because debt is a negative externality but not equity. Indeed, improving economic efficiency requires reversing the present corporate income tax discrimination favoring debt by making dividends tax deductible but not interest. This would lower the after-tax cost of equity while raising that of debt, thereby encouraging equity and discouraging debt financing. Consequently, corporate financial risk would fall, resulting in a fall in corporate bankruptcies and job losses, shallower recessions, greater capacity for business risk-taking, and faster economic growth, potentially saving Western governments tens of billions of dollars during recessions.

The present tax bias also extends to the household sector. Thus, the personal income tax code has an interest deduction provision that lowers the after-tax cost of mortgage interest but without a corresponding tax deduction for rent. This encourages indebtedness, a major negative externality. Such tax treatment is also unfair and regressive because the incomes of those who rent are likely to be lower than those who have mortgages. Hence, removing this tax bias by giving a comparable treatment to rent or replacing the interest deduction with a housing deduction for all is not only economically sound, but also fairer and less regressive.

At this time, we can only speculate by how much indebtedness would fall if all the tax favoritism of interest is eliminated, or better still reversed, but it would likely be a significant economic adjustment in the right direction.

4. Pigovian taxes

As stated previously, externalities cause misallocation of resources, inefficiency, and market failure. They arise because market forces fail to internalize all costs and benefits of a good or service, resulting in a divergence between private and public benefits or private and public costs because prices are too high or too low, respectively. Governments can alleviate this condition by providing subsidies or imposing taxes to encourage beneficial or discourage harmful consumption, respectively.

Professor Arthur Pigou, the eminent English economist, formalized the concept of externalities and was the first to recognize that the taxation of demerit goods not only raises revenue for the treasury but also, by restricting the consumption of demerit goods, improves public welfare (Pigou, 1920). Nowadays, such taxes are labelled Pigovian. Pigovian taxes raise the private cost of demerit goods to levels closer to their public cost, thereby restricting their consumption and improving welfare. The additional tax revenue they generate also helps pay for the additional public cost associated with the consumption of demerit goods. For example, the spillover effects of excessive alcohol consumption include death, injury and damage to property due to car accidents, absenteeism from work, health costs caused by impairment of the brain, liver, heart, and other organs, shorter life expectancy, addiction, social problems, and harm to the family fabric. These considerable social costs are not included in the price of alcohol. Hence, many governments impose an excise tax on alcohol to restrict its consumption. A similar case on health grounds is made to justify imposing an excise tax on tobacco.

For a long time, coal and petrol were viewed as fuels without regard to their polluting effects. In recent decades, however, public awareness has improved, calling for restricting the pollution caused by these hydrocarbons. As a result, a range of measures have been adopted to curb their use, such as heavier taxation of petrol, particularly in Europe, and encouraging substitutes such as electricity from cleaner sources like wind power and solar energy. It is high time that a similar awareness emerges regarding the use of debt financing with comparable measures to restrict its negative effects.

Inexplicably, the literature continues to sidestep a profound discussion of interest. For example, *The Theory of Externalities, Public Goods, and Club Goods* (Cronen and Sandler, 1996) presents an extensive discussion of externalities and Pigovian taxes but – as with other books on the subject – makes no mention of the negative externality of interest bearing debt or the need to tax it.

4.1 Taxing interest

As stated previously, the full cost of interest is not just its nominal amount but also the phenomenal cost of the crises it seeds, including lost jobs, profits, homes, and tax revenue to say nothing of the escalating cost of bank bailouts. Indeed, most major crises in the past two centuries can be traced to excessive interest bearing debt. Clearly, the public cost of interest far exceeds its private cost (the nominal interest), precisely the definition of a negative externality such as pollution, albeit, an imperceptible financial pollution. Pollution of the natural environment is physical while financial pollution is intangible, but just as real. Regrettably, while there are now a variety of restraints to curb physical pollution, there are still no comparable restraints on financial pollution; it continues to surge in parallel with

indebtedness. It is testimony to the power of banks that most goods and services are subject to tax but not lending, despite its huge negative externality.

Hence, a financial-pollution excise tax is essential, if long overdue. A suitable tax base would be the value of all new debt instruments such as loans, bonds, deposits, inter-bank lending, and central bank lending. It should also apply to short selling and derivatives in an appropriate fashion.¹³

What is the proper rate for taxing financial pollutants? The social cost of interest-bearing debt runs into the trillions of dollars, making any tax on debt, however huge, too small. Hence, banning interest altogether is economically logical, but it should not be implemented given the present pervasiveness of debt. Weaning the economy from debt needs to be a gradual process to avoid jolting the economy because economies need time to adjust and adapt.

Accordingly, the initial tax rate needs to be a small fraction of the social cost of debt, at say 0.5 percent per annum applied to new debt; however, the tax-rate on new debt would need to be increased annually by a similar amount until the economy is substantially weaned off debt. This would progressively discourage new borrowing without eliminating it outright. A lower rate would slow the adjustment process while a higher rate would make it faster. Moreover, in an inflationary environment, where interest rates are very high, the tax rate ought to be further linked to the prevailing nominal interest to achieve its objectives. One potential complication is that as the tax rate progressively increases over time, lenders would have a growing incentive to present their lending activities as trade transactions or equity financing to evade the tax; however, an effective tax code could easily pinpoint debt financing.

Administratively, the treasury could require the originators of interest bearing debt and financial brokers to collect the tax on its behalf in the same way that merchants collect sales taxes on behalf of the government.

5. Forms of alternative finance

The distinguishing feature of debt versus equity financing is that equity entails the assumption of business risk and therefore non-payment of dividends or principal does not constitute an event of default. There are several equity alternatives to debt. Foremost among them is common stock. In addition, certain types of preferred shares can be properly classified as equity rather than debt, provided they do not have clauses pertaining to cumulative dividends, renegotiation of terms in the event of interruption of dividends, capital prepayment triggered by financial difficulties, or priority in the net assets of a company in the event of liquidation. On the other hand, inclusion of these terms gives the preferred stock debt features with corresponding negative externalities.

The tax advantages enjoyed by debt have inhibited equity financing and the development of equity alternatives. Thus, if dividends become tax deductible under a revised corporate income tax regime, then preferred shares could become a significant source of corporate

¹³ A short seller borrows the security that he (she) sells short, resulting in a contingent loan to the owner of the security that is shorted, with the loan amount fluctuating in line with the market price of the security. On the other hand, derivatives, which Warren Buffet calls weapons of mass financial destruction, are best banned altogether because of the extraordinary risk they entail or, at a minimum, heavily taxed.

financing. Furthermore, a variety of tailored equity instruments for specific purposes could be developed; one such instrument for housing finance, *Equity Participation Certificates*,¹⁴ has been proposed, with interesting economic and financial implications for banks and homebuyers, alike. The imposition of an excise tax on debt would radically accelerate this process.

5.1 Effects of alternative finance

Since the replacement of debt by various forms of equity finance should be a gradual process so as not to jolt the economy, the benefits from replacing debt with equity finance would also be realized gradually. Such benefits are expected to reverse the negative effects of indebtedness; thus, we can expect, among other effects, shallower recessions, reduced household losses caused by bank repossessions of their homes, a decline in corporate bankruptcies, a reduction in the cost of bank bailouts, a fall in economic uncertainty, lower unemployment, faster economic growth, and improved Pareto optimality and resource allocation.

The proposed changes to the tax code are also expected to affect the business of banking and monetary policy. It would likely induce banks to gradually change their business model, evolving into giant providers of equity instead of debt finance, by acting as a new form of fund managers; furthermore – in the absence of loan defaults – bank profitability would likely improve and the severity of periodic banking crises and their associated costs to the banks would likely subside.

The evolution to a substantially equity financed economy would also significantly reduce the role of monetary policy and, with it, the role of central banks in arbitrarily setting the rates of return in an economy. At the same time, the role of fiscal policy in managing the economy would grow in importance. In addition, as new debt shrinks so does the banks' role in creating new money, thereby the treasury would reap a financial windfall in the form of a monetary dividend through the provision of a growing share of the increase in money supply that is required by the economy.

6. Concluding remarks

The problem of interest bearing debt has echoes of a famous children's tale by Hans Christian Andersen, *The Emperor's New Clothes*. Briefly, the story is about two tailors who assured the king they would produce for him the best suit ever made but it would be invisible to idiots. Thus, the king's entourage and the king himself hardly dared to speak out that the suit is invisible lest it indicates they are idiots; as a result, the king ended up parading in the nude before his subjects. Similarly, the bankers have convinced the world that without interest bearing debt lubricating capitalism the capitalist economic engine would seize. Economists, financial analysts, and political leaders have observed the repeated banking meltdowns without daring to declare banking defunct. Thus, financial fiascos have persisted. Rescuing the banks and the rest of the world from this absurd situation must begin by facing the

¹⁴ For a full description of the mechanics of Equity Participation Certificates see Al-Nakeeb, 2016, Chapter 15.

economic reality: interest bearing debt is a large negative externality. Still, one cannot underestimate the banks' instinctive resistance to this conclusion.

In any case, establishing that interest-bearing debt is a major negative externality is of no consequence without satisfactory remedial measures. The solution requires government intervention to improve Pareto optimality by (1) ending the implicit giant subsidies offered to banks, (2) removing the tax favoritism of debt over equity finance, and (3) treating debt as a demerit good that requires a Pigovian tax to curb its pervasiveness. These measures are certain to encourage equity finance, discourage debt, and encourage the evolution to a more robust banking model that increasingly provides equity instead of debt financing. Still, a precondition for their adoption is a properly functioning democracy that can withstand the political clout of big banks.

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