Prime Minister
Econ Pol.
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To glance. This is a Treasury note which has been sent to the Bank. Any scheme involves difficulties, but I think it ought to be possible to construct something for introduction at Report Stage of the Finance Bill.

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20/3

SECRET

BANK PROFITS

The Problems

1. This note considers the problems that:-

i) clearing banks are making very high profits relative to the rest of the corporate sector;
ii) these profits are in part the product of monetary policy and not of the banks' own acumen or efficiency;
iii) despite the high profits, tax paid by clearing bank groups is likely to be minimal;
iv) more revenue is needed in 1980-81;
v) pressure is building up to tax these profits soon to improve the chance of meeting other objectives.

The Present Position

2. Fully retrospective taxation of 1979 bank profits has been ruled out. An excess profits tax seems impossibly complex, and undesirable in terms of Government policies. Changes in capital allowances though needing consideration (see paragraphs 7 and 8) would have no revenue effect in 1980-81. The same is true of various ideas for widening the tax base in the financial sector which are now being studied. There remain possibilities for various sorts of levy on windfall profits in 1980-81.

Tax Schemes

3. In concept, windfall profits arise when high interest rates have significantly widened the average margin for banks with a significant proportion of non-interest or low-interest bearing deposits. To levy on these profits, it would be possible to construct either a percentage levy on sight deposits or to tax away a percentage

of the difference between the 'normal' and the current average level of interest rates, less interest paid, on the sterling deposit base. Outline schemes are at Annexes A and B. It seems likely that either scheme could yield £¼-½ billion. If the money is to be paid in 1980-81 then Scheme A contains a lesser degree of retroaction than Scheme B.

Loans to the Government

4. Another possible approach to the problem of bank profits would be to call for (non or low interest bearing) deposits with the Government. Such deposits could be either:-

i) a voluntary means to ease the presentational problems of bank profits;

ii) a statutory scheme designed to produce a significant financial gain to the Exchequer.

For such schemes, the loans could be permutations of small or large, interest or non-interest bearing, liquid or illiquid. Non-interest bearing, illiquid deposits would yield the Government a benefit equivalent to Treasury Bill yield on the amount held over the time held. Such deposits would put the banks under reserve asset pressure and would raise relative rates on reserve assets and probably short rates generally. For these reasons, deposits on any substantial scale would need either to be counted as reserve assets and be available to be drawn in case of a liquidity squeeze on an individual institution, and/or bear interest. But the scheme is pointless if a market interest rate is paid and if the deposits were reserve assets then there would be a switch of funds away from the discount market perhaps with major structural consequences.

5. Further difficulties are that the present arrangements for the (voluntary) SSD scheme make it difficult to see how the banks could also be asked to place, voluntarily, further small amounts of illiquid non-interest bearing deposits with the Government. Moreover, small amounts do not correspond to any presentational points related to the

problem of bank profits. For example a credible profit equalisation reserve deposit in respect of 1979 profits would amount to some £500 million which would cost the banks of the order of £90 million if held for a year and would reduce the reserve asset ratio to around 12.25%, consequently raising the relative rate of interest on reserve assets. Pressure could be eased by phasing the uptake of the deposits but this is also true of a simple levy which would cause far less short term structural disruption.

6. One means of avoiding these difficulties would be to place interest bearing Government deposits with the banking system and take an equivalent amount from them in non-interest bearing loans to the Government. It would have to be agreed that the Government deposits did not add to sterling M3 : in this case the arrangements would not affect interest rates or the liquidity or structure of the financial system. While this scheme appears structurally foolproof it is so clearly a device to secure a flow of income to the Government that it has little advantage over a tax unless its incidence could be made more discretionary, which seems unlikely.

Withdrawing Existing Allowances

7. The argument for levy schemes turns largely on the proposition that the banks can afford to pay more tax than they do (and that the money is needed elsewhere). A simpler route into that dilemma in the longer term would be to curtail the allowances which presently shield existing bank profits from taxation. Effectively, such a route would mean action to curtail capital allowances available for assets leased to others.

8. A solution along these lines has the great merit that, whilst it can be non-discriminatory as a tax measure, it falls in practice most on those whose profits are now most in question. It is thought that something around 85% of present lease business is done by financial institutions; and perhaps of the order of 75% within the clearing bank groups. Assuming that new lease business may be some £2½ billion in 1980, then to abate the first year allowances to, say, 75% could produce

some £150 million in 1981-82 and some £300 million in the first full year, diminishing thereafter. An abatement to 50% doubles these figures. Alternatively, capital allowances might only be given against profits on leasing activities thus bringing most profits from banking activities fully into mainstream corporation tax. The yield might be £500 million in the first full year. Either change would also reduce finance leasing from the non-bank company sector, which would be an advantage. The second, in particular, would sharply reduce the attraction of lease business to new entrants to that business. The great disadvantage of this route is that while it yields no revenue until 1981-82 the increased cost of investment finance to the manufacturing sector would begin at once.

Conclusion

9. There will need to be a reference to clearing bank profits in the Budget speech. Before then, more work is needed on the feasibility and effects of the possible schemes - in particular tax changes - which have been identified. It is suggested that further study should be undertaken jointly between the Treasury, Treasury Solicitor and Parliamentary Counsel, Inland Revenue and Bank. There should be a report back in time to consider whether or not any legislative action should be taken in the Finance Bill.

H M TREASURY
12 March 1980

ANNEX A

A Levy on Sight Deposits

The levy would be statutory. An outline scheme is as follows:-

a) the base for the levy would be UK banks sight deposits at the most recent make up day before announcement (possibly an average of 3, or even 6, make up days should be allowed - but all in the past);

b) the rate of call should not be greater than the difference between an assumed 'normal' interest rate and current market rates;

c) subject to that (unreal) constraint the call could be set to produce the yield which the Government wanted - 2% for example could well look reasonable;

d) banks might have to be allowed some offset for interest paid on those sight deposits which do attract interest (one fifth of the interest rate offered on sight deposits on that date might be reasonable in relation to a 2% call);

e) payment of the levy could be staged so as to allow the banks to pay from cash flow, minimising upward pressure on interest rates.

The primary purpose of the scheme is a reduction in the PSBR but its monetary effects should also be favourable. In the worst case, if bank lending was unaffected, the banks would finance the levy by extra deposits but the PSBR would be lower so that £M3 would be unchanged and DCE falls. If the banks reduced their lending because of lower reserves following the levy then £M3 also falls.

ANNEX B

A Levy on Total Deposits

An outline scheme for the calculation might be

Total deposits, private sector, excluding overseas on 19 March 1980 (or 16 January)		100
Average MLR in previous 12 months	16%	
Notional allowances for expenses profits etc	8%	
Net available fund	8%	= 8
Actual average interest paid on deposits in question		5
Notional excess available		3
Tax at 20%		0.6

As MLR falls and/or actual interest paid rises, the tax automatically liquidates itself.