Chancellor scrambles for sources of income to close £32bn hole in state finances – what are his options?

Desperate times call for desperate measures and, as the new chancellor scrabbles for sources of income to close a £32bn fiscal hole, Jeremy Hunt appears to have alighted on the banking sector.

The Financial Times is reporting that **Mr Hunt**'s forthcoming budget on 31 October is expected to include a raid on the banks – as well as an extension of the current windfall tax on profits in the oil and gas sector – as he seeks to raise money.

There are a couple of obvious options available to the chancellor.

Image:

PM Liz Truss and her new chancellor Jeremy Hunt at PMQS
The first is to leave untouched the current 8% surcharge on bank profits over £25m. This was a levy imposed on the banks by George Osborne, the former chancellor, in his 2015 summer budget and which came into effect the following year.

The measure was introduced by Mr Osborne as a replacement for the bank levy introduced in 2011 in the wake of the global financial crisis and which was applied to the global balance sheet assets of British banks and to assets owned by the UK operations of foreign banks.

By 2015, it was becoming clear the levy was damaging the UK's attractiveness to banks, while talk was in the air of HSBC moving its global headquarters away from the UK because of it.

The surcharge was Mr Osborne's attempt to ensure that the UK remained competitive but that banks continued to make what he called "a fair contribution" in the wake of taxpayer support given to the sector during the financial crisis.

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HSBC subsequently said, not long afterwards, that it would be retaining its global headquarters in the UK.

However, since then, **Brexit** has happened and a number of EU countries have intensified efforts to persuade international banks to base more of their operations and jobs outside the UK and in cities like Paris and Amsterdam.

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Aerial view of the City of London skyline

Accordingly, the banks have lobbied to get the surcharge removed or scrapped. They appeared to have succeeded when, in October last year, **Rishi Sunak**, the last-chancellor-but-two, announced he was cutting the surcharge from 8% to 3%. That was partly to reflect that, at the time, he was raising corporation tax from 19% to 25%. In fact, though, Mr Sunak's measure would actually have taken the effective corporation tax rate paid by the banks from 27% to 28%.

When **Kwasi Kwarteng** recently sought to scrap the planned corporation tax increase, however, he announced that the surcharge would be kept at 8%.

Now that Mr Hunt has said that the increase will go ahead, though, there had been an expectation among the banks that the surcharge would come down in the way that Mr Sunak had originally intended.

But it seems Mr Hunt may be tempted to keep it in place – which would effectively mean that, from the new tax year, the banks would be paying an effective corporation tax rate of 33%.

This is something that has alarmed the banks.

UK Finance, the industry body, has already warned Mr Hunt not to put at risk the competitiveness of the UK’s banking and finance industry.

Image:
The Bank of England

The second possible option available to Mr Hunt is an idea that has been floated by, among others, Sir Paul Tucker, the former deputy governor of the **Bank of England**.

He has suggested the government reconsiders the current arrangement under which the Bank pays interest to lenders on the reserves they park with it. The banks, which currently have some £947bn in reserves at the Bank (largely as a result of Quantitative Easing), are paid interest on those reserves at the Bank’s main policy rate – Bank Rate.

That was less problematic when Bank Rate was just 0.1%, as it was until December last year, but now it is increasing – the current rate of 2.25% is expected to increase to at least 3% at the Monetary Policy Committee’s next meeting – the cost is rising.

Image:
Former deputy governor of the Bank of England, Sir Paul Tucker

In a paper written for the Institute for Fiscal Studies, published on Friday last week, Sir Paul suggested the Bank consider introducing what he called “tiered remuneration for reserves balances”.

Under this arrangement the Bank would pay lenders little or no interest for a large portion of their reserves – although it would still have to pay interest on a small fraction of those reserves in order to ensure that the Bank’s policy rate remained effective in money markets.

Sir Paul added: “Such a change would have considerable benefits for the public purse. Given the Bank currently holds around £800bn of gilts, Britain’s debt-servicing costs are highly sensitive to even small changes in the path of Bank Rate.

“Taking current market expectations for a substantial rise in Bank Rate together with the Bank’s current published plans for unwinding QE, the implied savings would be between around £30bn and £45bn over each of the next two financial years.

“These are big numbers, and would of course be even bigger if the Bank does not actively unwind QE via asset sales but lets it roll off as bonds mature.”

Not an ‘easy win’ for government

Such a move, though, would not amount to what Sir Paul warned might be seen as an “easy win” for the government. He pointed out that the banks might need income on reserves to “sustain them” through future possible economic shocks.

He said there would also be a question over how the banks passed on what would amount to a lowering of their incomes – for example by raising the interest charged to borrowers or cutting the interest paid to savers and depositors. Such a move could have the result of reducing lending by the banks.

Image:
The Bank’s governor, Andrew Bailey

Sir Paul also pointed out that changing the reserves regime might also be regarded in some quarters as an interference with the Bank’s independence – something of which financial markets would take a very dim view.

Andrew Bailey, the Bank’s governor, has argued in favour of the current arrangement because it enables changes in Bank Rate to be transmitted to the broader economy.

Jean-Baptiste Colbert, the finance minister to the French ‘Sun King’ Louis XIV, famously said “the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing”.

Given current sensitivities over the Bank’s independence, generated by the Conservative leadership contest, Mr Hunt may conclude that the ‘tiered reserves’ approach may risk too much hissing from Threadneedle Street.

But he may well conclude that leaving the banking surcharge where it is may be a comparatively easier way of plucking more feathers from lenders – even if it does risk undermining the sector’s competitiveness.