The Financial Transactions Tax Versus the Financial Activities Tax

Daniel Shaviro
NYU Law School

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Why has the European Commission proposed an FTT?

The main stated grounds are (1) to ensure a fair contribution by the financial sector, (2) to respond to under-taxation of the sector, and (3) it "might be an appropriate tool to reduce excessive risk-taking." (From Commission Staff Working Paper, Executive Summary of the Impact Assessment.)

Other possible grounds: harmonize FTT-like taxes that EU countries may be doing anyway; political feasibility & revenue?

Grounds for rejecting FAT are unclear. FTT's greater revenue potential & direct impact on risks from excessive trading outweigh "higher risk of relocation of transactions" & higher negative effects on GDP & employment? (Again, from the Executive Summary.)

Overview of talk: I consider FAT clearly preferable to FTT, leaving aside harmonization & political feasibility rationales for the latter.

But one possible rationale (NOT identified by the Commission staff) may support enacting an FTT, whether or not an FAT is enacted.

Ensuring a “fair contribution” by the financial sector

This goal is cited by both the Commission & the IMF Staff in its G-20 Report proposing an FAT.

3 problems: (a) If backward-looking, how can a tax enacted in 2012 or later catch those who benefited from bailouts in 2008-2009?

(b) If forward-looking but distributionally motivated (rather than addressing marginal incentives), similar issue. Incidence effects from new information about the tax; tax capitalization afterwards?

(c) Who or what is the “financial sector”? Beware the pathetic fallacy; a sector as such can’t bear a tax any more than corporations can bear the corporate tax.

We need to think in terms of people – financial institution shareholders? High-ranking employees? Consumers who use financial services?

Who should bear the "fair contribution"?

Diversified shareholders are not a sensible target for bearing the "fair contribution." Nor are consumers unless they are the ones imposing risks (an efficiency rationale; more on this shortly).

Financial sector owner-employees & other highly compensated employees are presumably the people we have in mind.

FAT is potentially well-designed to impose a tax burden on them, whether by taxing (a) actual rents that they capture or (b) fake rents that reflect their imposing tail risk on everyone else.

For FTT, unclear why they'd be expected to bear a tax levied on sales to consumers. Even if a transition effect on market size, would this address the problem of outsized returns?

For transactions between financial institutions, note inefficient design: tax on intermediate production, incentives for vertical & horizontal integration.

Also a tax on saving & investment; progressive in the first instance but could affect capital stock; why *this* tax on saving & investment?

Under-taxation of the financial sector

Usually attributed to non-application of VAT to financial services.

True enough, but also a problem (& roughly the same problem) under income taxes.

The problem: financial services to individuals are implicitly deductible when provided for "free" in lieu of paying market interest on deposits.

Note checking accounts that pay little (if any) interest but offer free checking, free ATM use, etcetera.

This may induce, not just over-use of these services, but an inefficient fee structure for them. (Whereas VAT exclusion merely induces over-use.)

Is the financial sector too large wholly apart from tax, bailout subsidies?
(E.g., what exactly explains the scope & market value of pre-2008 CDO activity given its evidently limited value as a diversification tool?)

Responding to under-taxation of the financial sector

Again, we should think not about the "sector" as if it were some unitary thing, but about particular activities that are under-taxed or (for other reasons) over-supplied.

Once again, the FAT scores well. If a tax on rents, it's reaching things that can efficiently be higher-taxed than other activities.

Plus, inquiry into *why* these rents exist might support viewing them as related to various bads (e.g., creating barriers to entry, crony capitalism, abuse of opacity & complexity to exploit gullible consumers).

Likewise, the FAT scores well if it is identifying a proxy for tail risk not borne by the makers of risky bets.

FTT: securities trading is not as such under-taxed – indeed, income taxation deters gain realization – unless one is making an externalities argument.

This brings us to the 3rd rationale (deterring excessive risk-taking).

The FTT and excessive risk-taking

Clearly the FTT doesn't target the *type* of excessive risk-taking potentially addressed by the FAT ("heads-I-win, tails you lose" bets by financial firms).

But what about "excessive" trading? Let's back up & ask why one might think of trading as imposing social costs on others to begin with.

Simple neoclassical world with complete markets, all players are pure price-takers, etc.: transactions have expected utility to participants & no effect on anyone else. Trading can't be "excessive" as posited; no reason to tax it.

The claim: some players who trade a lot (e.g., using automated trading programs) can affect prices, such as by accentuating downturns.

With thin markets, traders can also create positive externalities – providing counterparties so that other would-be traders can find a partner & realize the surplus they attribute to making a fair-value trade.

Addressing trading externalities

The problem: trading as such isn't bad, hence not a proper target for Pigovian taxation – need a filter to identify "bad" trading.

Not theoretically impossible in the case of the FTT. E.g., suppose trading "more" was a good enough filter.

Then, even if the FTT's taxing *all* trades might be bad, its taxing (on average) "bad" trading more might yield net efficiency gain.

Unfortunately, empirical studies of whether the FTT thereby reduces market volatility tend to reach a negative conclusion – in addition to identifying other efficiency costs.

But I will leave this topic to the next speaker (Matheson), who has studied it more fully than I have.

Another rationale for the FTT?

I'm therefore unpersuaded by each Commission rationale for the FTT, apart perhaps from that of increasing FTT coordination & consistency.

But note another possible rationale. From a social standpoint, people may invest far too much effort in seeking trading gains.

Cf. Hirshleifer (1971) on innovation – getting there 5 seconds before everyone else yields only modest social gains, yet can offer a huge private payoff.

Same point about trading based on new information, 5 seconds before it changes market prices.

Also a possible "internalities" argument – if people trade too much due to overconfidence about their trading ability, an FTT that caused them to trade sufficiently less might conceivably leave them better off. (Cf. taxing smoking.)

This suggests a colorable case for a modest FTT – but not *instead* of the FAT & not to address past & future financial crises.

Note also the "compared to what" issue for countries with large fiscal gaps & political economy constraints on rational revenue-raising.