The Financial Transactions Tax Versus (?) the Financial Activities Tax

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Intervening in a horse race

Prepared for conference (Amsterdam 12/9/11) discussing recent European Commission (EC) proposal to enact an FTT (financial transactions tax).

Natural contrast to Int'l Monetary Fund (IMF) staff proposal to enact any of 3 variants of an FAT (financial activities tax).

Key difference: gross tax on certain sales, vs. net tax on a broader range of activities.

Discussion is organized around (but not chained to) stated rationales for taxing financial firms.

Main conclusions: (1) I favor a hybridized version of the 3 FATs discussed by the IMF (and generally reject stated rationales for the FTT).

(2) A possible FTT rationale (not identified by the EC) might conceivably support its enactment, whether or not an FAT is enacted.

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."

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

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

Possible unstated political feasibility rationale? (From FTT's nominally lower rate, popular identification as the "Robin Hood tax.")

FTT: History and Rationale

> 200 years old (U.K. 1808), reflecting the appeal of its “broad base” (??) and revenue potential at very low statutory rates.

Modern theoretical support is sometimes based on “beauty contest” model of financial markets (suggesting high volatility, low informational content).

Tobin 1972: FTT on currency transactions to curb volatility.

Keynes 1935: stock transfer tax (STT) to deter “speculation” relative to “enterprise;” concern about volatility secondary to claim about resource misallocation.

FTT Drawbacks

A tax on gross, not net, proceeds (hence, e.g., no direct distributional rationale for discouraging taxable activity).

Leads to cascading taxation of inter-business transactions.

Distorts sell vs. hold decisions, which may already be income tax-distorted in the same direction.

Avoidability: location, labeling (of taxable sales & of taxable transactions). Note Sweden's experience in the 1980s, rise since then of derivatives.

The EC's FTT Proposal

Broad definitions of financial transactions, taxable firms, applies to derivative transactions (though how may be problematic).

Residence-based application – but can avoid by using non-EU affiliates.

Exempted transactions include currency exchange, primary issuance of securities, consumer lending, insurance. Room for game-playing (including by participating countries)?

Cascading application if multiple taxpayers in a given transaction, apparently applies to intra-group (and intra-entity?) transactions. Hence, requires transfer pricing.

Optical goal of targeting the financial sector, while ostensibly not burdening households small-to-medium-sized businesses, seems to have yielded some odd choices.

The IMF's FAT Proposal

Key shifts are to net rather than gross taxation, & taxing all activity by "financial firms" rather than just asset sales.

FAT-1: While meant to be VAT-like, uses distinct methodology & rationale.

VAT: taxes firms' net cash flow, with refundability. Resembles business income tax, but with (a) expensing, (b) wages not deductible (but also not includable by workers), (c) all financial flows ignored.

VAT exclusion for financial firms exempts consumer services (e.g., from bundling free checking & ATM use into the interest rate spread), though it also leads to inter-business over-taxation.

Same preferences in the income tax for financial services, even though financial firms are taxpayers!

FAT-1

FAT-1: Expand the VAT base by also taking into account financial flows by financial firms (including loan principal); non-financial firms have no tax adjustments.

ACE method would ignore loan principal but offer a cost of capital allowance (COCA) for corporate equity; ACC method would use COCA (in lieu of observed interest) for debt as well as equity.

Refundability presumably applies to COCA as well as negative cash flows.

The FAT-1 taxes consumer services but also business inputs – rationalized via existing tax preferences & expected bailout subsidies. In response to cascading issue, IMF Staff counsels keeping the rate low.

Imperfect fit with the underlying problems motivates considering other FAT variants.

FAT-2 and FAT-3

FAT-2: Allow deduction for ordinary wages. Rationale: since the normal rate of return is (expressly or effectively) exempt, a tax on rents.

These days, looking for rents in the financial sector may be a bit like looking for good songs in the Beatles' catalog. (Is Dean Kramer in the house?) From tournament economics? Opacity & deception? Other?

If done ACE or ACC-style, refundability presumably still extends to COCA.

FAT-3: Addresses undue risk-taking (nickels in front of a steamroller) that reflects the "heads I win, tails you lose" bets with hidden tail risk.

All this requires is nonlinear / rising rates, which could be done many ways. But the IMF's FAT-3 would have a huge COCA (say, 15%) that presumably isn't refundable.

My preferred FAT variant

By cheating (looking ahead to the end once I was done writing), I now realize what my preferred variant might look like.

FAT-1 plus FAT-2: Given the rationale for some net tax on the sector, but the stronger case for taxing rents, why not allow ordinary wages to be credited at a rate somewhere *between* 0 and the full FAT rate?

Then add in the gain-loss asymmetry of FAT-3: No need to raise COCA to 15% - just provide more modest non-linearity. E.g., nonrefundability in general or for COCA deductions? Other?

We now have identified 2 contestants: the EU's FTT & the IMF's / my FAT 1-2-3. Let's run them through a horse race (at least initially) organized around the factors that the EC identifies.

The EC's factors

1) Raising revenue – The right goal is revenue with attractive efficiency / distributional features.

FTT's ability to raise a lot at a low statutory rate is merely an optical advantage; the gross rather than net base is clearly worse unless have specific rationales for it (a la Keynes or Tobin).

2) Fair & substantial contribution from the financial sector – This means, presumably, owners with large stakes / control & high-ranking employees

Hard to look back (they've left the crime scene). If looking forward, note the issue of tax capitalization.

FAT 1-2-3 is clearly preferable to FTT. It hits rents (& risk-takers), rather than just imposing a fee that, while it might shrink the financial sector a bit, might in the main be passed on to customers.

Factor 3: reducing undesirable risk-taking & stabilizing markets

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).

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

But with thin markets, traders can also create positive externalities by serving as counter-parties.

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 mixed or negative conclusion – in addition to identifying other efficiency costs.

Note the lack of a clear relationship between, say, bubbles & ease of trading (case in point, real estate markets).

Other issues

EC's 4th factor is coordinating FTTs that EU countries might impose anyway. Significance of this concern is unclear.

OTHER:

--FAT's broader coverage of the financial sector responds more directly to sector-wide tax and bailout subsidies.

--FTT has the disadvantage of favoring debt over equity (both included, but the former tends to be traded less).

--Tax competition is probably more of a problem for the FTT.

--Defining taxpayers is probably more of a problem for the FAT.

-FTT may be more politically feasible (although at present, apparently neither is).

Another rationale for the FTT?

From a social standpoint, people may invest 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.