The Financial Activities Tax

Victoria Perry
International Monetary Fund

Bruegel-IMF Workshop
Brussels
September 18, 2012

Outline

- Why a FAT?
- What is (are) the FAT?
- FAT administrability issues

Why a FAT?

- **Two-fold rationale**
  - Raise revenue (a “fair and substantial contribution”) “from” the financial sector; while…
  - **Reducing** economic distortions arising in connection with the sector

- **With the variant of FAT chosen determining the balance of these two**

What is the “FAT” proposed by IMF?

- **Essentially, an addition method VAT on value-added in the financial sector**
- **Tax liability would be imposed on financial sector institutions; and collected from them**
- **Three variants:**
  - FAT1—replacing the missing credit-invoice VAT on margin based transactions (“wages plus profits”), and reducing the net undertaxation of the sector’s value-added
  - FAT2— tax on “rents” (profits above a normal return, plus “excess” wages)
  - FAT3—designed to minimize risk-taking by taxing very high returns asymmetrically with losses

Some examples of “FAT-like” taxes

- Iceland
- Israel
- Province of Quebec, Canada
- Denmark
- France
- Italian IRAP

Four issues affecting FAT administration

- Defining the “profit” base
- Defining “excess” wages (FAT2 and FAT3)
- Integration with credit-invoice VATs
- Cross-border issues

Defining the profit base

- “profit” in value-added (consumption) based tax differs from that covered by an income tax...
- ...bearing only on “rents” (returns in excess of normal return to/cost of capital)
- Positive present value only if these exist

Defining the profit base (cont)...

Two main possibilities for implementing this

- **"R + F" (cash flow) base: add to net "real" flows the net financial flows (borrowing plus interest received, less repayments plus interest paid)**
- **Or the "ACE" method: start from "normal" business tax base, and deduct a notional return to equity**
  - Equity defined as subscribed capital plus accumulated retained earnings
  - Must define the appropriate notional return ("risk-free" rate)
- **The ACE method would be easier to implement as it begins with well understood accrual accounting**

Defining “excess” wages (FAT2 and FAT3)

- **Profits base would be the same as FAT1 (as that includes only “rents” anyway)**

- **Choice of wage levels somewhat arbitrary, but there are studies that attempt to determine “rents” in financial sector wages**
  - See, e.g., various “bonus” taxes already implemented

- **FAT3 would be more limited**
  - Tax “high” labor returns at an even higher rate (possibly limiting coverage to those with control over risk-taking)

Integration with credit-invoice VATs

- **For sales to final consumers, VAT with unrecovered credit for financial institutions, plus FAT1 replicates tax impact of a fully functioning credit-invoice VAT**
- **Problem is for non-financial businesses**
  - Either there will be cascading...
  - ...or, an implicit credit at standard VAT rate could be given for total payments to financial institutions, even though latter would not be within the credit-invoice scope
- **No country that has adopted variant of FAT1 has allowed any cross-crediting**
- **Simplest (rough) solution: accept cascading but therefore use low rate**

Cross-border issues

- **For FAT2 and FAT3, origin basis is most natural**
- **But for FAT1 destination basis would be most logical**
  - See, e.g., zero-rating of financial services exported outside EU under current system
- **This could be done...**
  - For wage component, would need apportionment
  - In an R + F method, ignore transfers to and from non-domestic
- **...but would result in cross-border transactions being taxed nowhere—imports would not fall within tax base abroad even if all countries adopted**
- **Best/easiest to use origin basis for all FAT?**