



The Financial Activities Tax

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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**



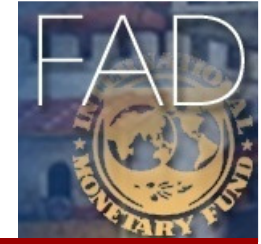
Four issues affecting FAT administration

- **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**



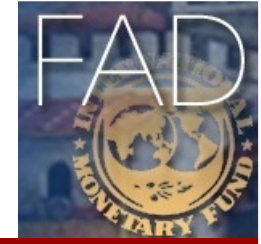
Defining “excess” wages (FAT2 and FAT3)

- 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?