The Financial Transactions Tax vs. The Financial Activities Tax

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In Europe and the United States, there has been much debate regarding whether, in response to the 2008 financial crisis, governments should enact a financial transactions tax (FTT) or a financial activities tax (FAT), which are commonly viewed as mutually exclusive alternatives. This report evaluates those alternative instruments, focusing on recent proposals by the European Commission and the IMF. It concludes that the case for enacting a FAT is considerably stronger than that for an FTT, mainly because the FAT focuses on a broad net measure, rather than a narrow gross measure, of financial sector activity.

The report further concludes that a rationale for the FTT not emphasized by the European Commission — to address wasteful overinvestment in seeking trading gains at the expense of other traders — could conceivably support its enactment, although it is uncertain whether the social benefits would exceed the costs. The questions raised by that rationale are independent of whether a FAT has been enacted.

Finally, the desirability of enacting an FTT may be affected by broader political economy constraints on revenue raising and on the pursuit of greater tax progressivity by alternative (including clearly superior) means.

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I. Introduction

On her deathbed, Gertrude Stein reportedly asked, "What is the answer?" but on hearing no reply, she added, "In that case, what is the question?"[1] In evaluating what new tax instruments, if any, should be levied on the financial sector in the aftermath of the 2008 financial crisis, we would do well to emulate Stein's focus on what question is being asked. We need to know what purposes are to be served by a tax on the financial sector before we can evaluate how best to advance those purposes.

The European Commission, in its recent proposal that the European Union adopt a financial transactions tax (FTT) that is directed mainly at secondary securities trading,[2] is commendably clear about the objectives that a financial sector levy might serve. It mentions (1) raising revenue; (2) ensuring an "adequate (fair and substantial)" contribution from the financial sector; (3) reducing undesirable market

[1] *See* Janet Malcolm, "Someone Says Yes to It," *The New Yorker*, June 13, 2005, at 148, 164.

[2] An FTT proposal has recently been introduced in Congress by Rep. Peter A. DeFazio, D-Ore., and Sen. Tom Harkin, D-Iowa. *See* Wall Street Trading and Speculators Tax Act, H.R. 3313 and S. 1787.

behavior and thereby stabilizing markets; and (4) achieving coordination between different member states' internal taxes.[3]

In my view, however, the commission is less persuasive in arguing that those considerations support enacting an FTT — particularly in relation to the alternative it identifies, which would be to enact instead some variant of a financial activities tax (FAT),[4] as recently proposed by the staff of the IMF.[5] I will argue that the considerations identified by the commission — some of which are more compelling than others — along with broader tax policy objectives, strongly support enacting a FAT (at least, assuming no other alternatives) while also raising serious questions about an FTT's desirability. Indeed, the case that a properly designed FAT is superior to the FTT is sufficiently compelling — not to mention unrebutted by the commission's analysis — as to leave one wondering why the commission came out as it did. As for the FAT, which to date has been somewhat underexplained, I will expand on, and in at least one respect, modify the IMF staff's analysis, while also explaining how one might combine the most appealing features of the alternative versions that it describes.

As it happens, however, there is potentially a decent rationale for enacting an FTT — albeit one that does not relate to extracting a ''fair contribution'' from the financial sector or to easing the risk of another 2008-style economic crisis. Instead, it relates to investors' incentive to seek trading gains at the expense of rival investors, whether by acting faster than their rivals on new information or by special talent (or luck) in ''anticipating what average opinion expects the average opinion to be.''[6] The competitive pursuit of trading gains can verge on being a zero-sum game. Moreover, even when some social benefit results from speeding the process whereby markets incorporate new information into asset prices, the private gain from being one microsecond faster than one's rivals may so exceed that benefit as to make a tax on the activity potentially appealing — at least if the substantial design obstacles that an FTT would face can be sufficiently well addressed to create optimism about its good effects' outweighing its social costs.

Given how little that possible rationale for an FTT has to do with the main objectives identified by the commission,[7] I believe that the FTT-or-FAT question is misguided. I will argue that a FAT should be enacted in any event — leaving aside possible further alternatives — for reasons pertaining to undertaxation of the financial sector and incentives for bad risk taking. But the case for a suitably redesigned FTT should rise or fall on wholly separate grounds, and largely without regard to whether a FAT is in place.

In this report, I first discuss the FTT and FAT models that have featured in historical and more recent discussion, including by the commission and the IMF. Then I evaluate the objectives cited by the commission, along with further tax policy objectives, and assess their relevance to the FTT-vs.-FAT choice that is being debated in Europe. Next I discuss the alternative rationale that potentially supports adopting an FTT. Finally, I offer a brief conclusion.

II. The FTT and the FAT: A Brief Overview

A. Prior Intellectual History of the FTT

FTTs have a long and varied history. They are commonly traced back to a proposal by James Tobin[8] that countries impose special taxes purely on one type of financial transaction: ''spot conversions of one currency into another, proportional to the size of the transaction.''[9] The commission's FTT proposal would exempt currency conversions,

[3]*See* Committee on Economic and Monetary Affairs, European Parliament, ''Draft Report on the Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC,'' (Feb. 10, 2012), at 7; European Commission, ''Commission Staff Working Paper: Executive Summary of the Impact Assessment,'' accompanying the document ''Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC'' (Sept. 2011), at 3-4. A further objective is to create international momentum toward the general adoption of FTTs.

[4]Several countries have adopted other bank taxes, often aimed at some measure of bailout risk and expected bailout cost. I will generally ignore those provisions, because their consideration has effectively been proceeding on a separate track from that of the FTT and FAT.

[5]IMF staff, *A Fair and Substantial Contribution by the Financial Sector: Final Report for the G-20* (June 2010).

[6]John Maynard Keynes, *The General Theory of Employment, Interest, and Money* 156 (1964).

[7]While the European Commission did not mention any such rationale for enacting an FTT, the Committee on Economic and Monetary Affairs of the European Parliament, in its 2012 draft report amending the commission's work, notes (at 15) investors' ''turn from long-term investments to short termism'' as another rationale. Also, the FTT that was recently proposed in the United States has been rationalized by its sponsors on grounds that are considerably closer to the line of argument that I suggest. For example, it is called the ''Wall Street Trading and Speculators Tax Act,'' and its lead House sponsor, DeFazio, emphasizes that Wall Street is a ''gambling casino'' and that an FTT would ''rein in speculation on Wall Street.'' *See* Josh Boak, ''Wall St. Trading Could Generate Taxes,'' *Politico*, Oct. 4, 2011, *available at* http://www.politico.com/news/stories/1011/65140.html.

[8]James Tobin, *The New Economies: One Decade Older* 88-92 (1972). Tobin, ''A Proposal for International Monetary Reform,'' 4 *Eastern Econ. J.* 153-159 (1978).

[9]*Id.* at 155.

which are the sole target of the so-called Tobin tax, while applying to transactions that the Tobin tax would not have reached — specifically, selling securities, such as corporate equities and bonds, on secondary markets (that is, only after their initial issuance).

Thus, the commission's proposal is actually closer to being a securities transactions tax (STT) than either a Tobin tax or an all-purpose FTT on all financial transactions.[10] That idea has considerably older antecedents. As early as 1808, English stamp duties on legal documents transferring title to property, including land or stock, started to be based on the value of the property being transferred,[11] making them a recognizable FTT precursor. John Maynard Keynes,[12] after noting that England imposed transfer taxes on securities trades, argued that the United States also should adopt "a substantial Government transfer tax on all [such] transactions . . . with a view to mitigating the predominance of speculation over enterprise in the United States."[13]

At first glance, Keynes's and Tobin's analyses are very similar, despite addressing markets for distinct financial assets.[14] Nonetheless, one can discern at least a slight difference in their emphasis. Both rely on Keynes's[15] famous comparison of financial investment to a newspaper's beauty contest in which

> the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view.

The analogy reflects that in short-term asset trading, fundamental value (based on the risk-adjusted present value of expected long-term cash flows) may matter less than "what average opinion expects the average opinion [regarding resale value] to be."[16]

Given that distinction between long-term fundamental value and short-term trading value, Keynes proposed to "appropriate the term *speculation* for the activity of forecasting the psychology of the market, and the term *enterprise* for the activity of forecasting the prospective yield of assets over their whole life."[17] He argued that speculation will often predominate in financial markets, especially if trading is easy and cheap, and that effectively turns financial markets into casinos, in which luck and mood shifts drive the action and asset prices fail to function as good signals of fundamental value: "When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."[18] By contrast, a world in which one could not trade so cheaply and readily "would force the investor to direct his mind to the long-term prospects and those only,"[19] thus strengthening the relationship between asset prices and fundamental value.

With speculation playing so central a role in financial markets, Keynes argued that Wall Street's success in directing

> new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of *laissez-faire* capitalism — which is not surprising if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object. . . . It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges.[20]

Tobin similarly saw currency exchange markets as working well in one sense but not another. They were highly efficient "in a mechanical sense: transactions costs are low, communications are speedy, prices are instantaneously kept in line all over the world, [and] credit enables participants to take large long or short positions at will or whim."[21] However, their efficiency in the "deeper economic-informational sense" was "very dubious." With

[10]As discussed below, what makes the European Commission's proposal not just an STT is that it also applies to derivative transactions.

[11]HM Revenue & Customs: Code of Practices 9 (2011). Stamp Taxes Manual, *available at* http://www.hmrc.gov.uk/so/manual.pdf.

[12]*See* Keynes, *supra* note 6, at 160.

[13]The United States levies very modest STT-like securities transaction fees to fund operations of the SEC, but they are typically ignored by analysts because they are so low.

[14]This similarity reflects, of course, Keynes's enormous intellectual influence on Tobin, whom *The New Palgrave Dictionary of Economics* calls "the leading proponent of Keynesian economics in the second half of the twentieth century." Donald D. Hester, *Tobin, James (1918-2002)*, in Steven N. Durlauf and Lawrence E. Blume (eds.), *The New Palgrave Dictionary of Economics* (2008).

[15]*See* Keynes, *supra* note 6, at 156.

[16]*Id.*

[17]*Id.* at 158.

[18]*Id.* at 159.

[19]*Id.* at 160.

[20]*Id.* at 159.

[21]*See* Tobin, "A Proposal for International Monetary Reform," *supra* note 8, at 157-158.

little available factual basis for confidently (much less reliably) projecting proper long-term currency value relationships, ''the markets are dominated — like those for gold, rare paintings, and — yes, often equities — by traders in the game of guessing what other traders are going to think.'' This created episodes of severe short-term currency price volatility, leading to the transmission to domestic economies of ''disturbances originating in international financial markets. National economies and national governments are not capable of adjusting to massive movements of funds across the foreign exchanges, without real hardship and without significant sacrifice of the objectives of national economic policy with respect to employment, output, and inflation.''[22] An ''internationally agreed uniform tax'' on currency trades, based on the value being traded, might reduce volatility by ''throw-[ing] some sand in the well-greased wheels''[23] through the expected reduction in transaction volume via the tax-induced increase in trading costs.

Tobin based his case for the Tobin tax on the claim that it would reduce market volatility. Thus, one could in principle refute his argument by demonstrating empirically that it would not increase asset price stability. Moreover, while Tobin shared Keynes's concern about speculation's impact on efficient resource allocation, as manifested in his skepticism about financial markets' efficiency in the ''deeper economic-informational sense,'' he used that more as a response to the concern that the Tobin tax might undermine efficient price revelation than as an affirmative motivation for the tax.

Keynes, while mentioning asset price and resulting macroeconomic ''instability due to speculation,'' did not so closely link the diagnosis and the proposed cure, given the issue of resource misallocation.[24] Accordingly, his argument for an STT might more readily survive empirical refutation of the claim that it would increase asset price stability. And whether it would succeed in improving the extent to which financial markets ''direct new investment into the most profitable channels in terms of future yield''[25] might be hard either to confirm or rebut empirically. There is not even general agreement about the importance of secondary stock market prices, with some arguing that they play no basic informational role in the economy[26] and do not significantly affect real resource allocation.[27]

There also is a distinction between Keynes's and Tobin's explanations of how short-term, beauty-contest-driven trading undermines the aspects of financial market performance that they emphasize. In general, lower trading volumes and longer holding periods are logically linked, all else being equal, since if you are trading less, you presumably are holding the financial assets in your portfolio, on average, for longer periods. But they are conceptually distinct. Tobin cares about trading volume, which he believes (as we will see, with at best mixed empirical support) leads to sharper price fluctuations, including through price bubbles and panics. Keynes appears to be focusing more on average holding periods.

A possible reason for that focus, if one shares Keynes's concern about the distinction between speculation and enterprise, is as follows. Except insofar as one anticipates profiting from a stock's actual cash distributions, whether from dividends or the ultimate liquidation proceeds, one cannot help being subject to the beauty contest problem, even if one waits 50 years to sell. After all, the value that potential buyers (as well as lenders) ascribe to the stock will always reflect the ongoing influence of ''what average opinion expects the average opinion to be.''[28] Keynes's claim accordingly must be that the longer you first hold the stock before seeking to sell it, the greater the likely effect of new information about fundamental value, even with ongoing noisy random variation from the beauty contest's vicissitudes. Thus, people who expect to hold stocks longer will pay more attention to enterprise and fundamental value, even if they can never ignore the concerns of speculation. Another argument, frequently made but not yet attracting consensus either for or against it, is that the prevalence of speculation may worsen corporate governance, by encouraging both the shareholders who might otherwise more carefully monitor managers and the managers themselves to embrace ''short-termism'' at the expense of focusing on long-term value enhancement.[29]

Those considerations suggest caution about too swiftly embracing Keynes's or Tobin's grounds for

[22]*Id.* at 154.
[23]*Id.* at 158.
[24]*See* Keynes, *supra* note 6, at 161.
[25]*Id.* at 158.
[26]Joseph E. Stiglitz, ''Using Tax Policy to Curb Speculative Short-Term Trading,'' 3 *J. of Fin, Services Res.* 107 (1989).
[27]Lynn A. Stout, ''The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation,'' 87 *Mich. L. Rev*. 645-651 (1988).
[28]*See* Keynes, *supra* note 6, at 156.
[29]*See, e.g.*, Stout, ''Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation,'' 81 *Va. L. Rev*. 687 (1995).

advocating an FTT, even if one believes (as I do) that the beauty contest metaphor offers an important and convincing insight into how financial markets actually function. The journey from undermining one's confidence in financial markets' efficiency in the "deeper economic-informational sense"[30] to embracing a particular policy response may not be as clear as Keynes and Tobin suggest.

B. Efficiency Problems With an FTT

Even if an FTT has desirable qualities for the reasons identified by Keynes or Tobin, it also has significant defects from the standpoint of efficiency. Indeed, without a significant positive rationale, the efficiency arguments against adopting it would be very compelling. Consider the following:

- An FTT applies to transactions' gross, rather than net, proceeds. Suppose I buy 100 shares of Siemens stock for $10,000 and then sell the same shares for the same amount. Under an STT, I will be taxed twice, despite not having gained any profit. An STT thereby discourages economic activity without (at least directly) advancing the distributional aim of making those who have fared better pay more. By contrast, taxes on net proceeds — for example, income taxes and VATs — while also discouraging economic activity, at least have the advantage of directly serving that distributional goal.
- An FTT imposes cascading taxes on interbusiness transactions. The more that the production process involves taxable sales from one business to another before the ultimate sale to a customer, the greater the tax burden on a product. For good reason, EU member states have mainly rejected these taxes since the rise of the VAT in the 1950s. Economic theory confirms that under plausible conditions, production efficiency is maximized, without any loss of the ability to achieve desired distributional goals, by not imposing those taxes.[31]
- Taxing sale transactions, while not taxing the decision just to hold particular financial assets, creates needless inefficiency unless — as Keynes and Tobin argue — the sales impose external costs on others or are correlated with otherwise unobserved flaws that merit tax discouragement. In complete markets where everyone is a price taker and there always are available counterparties, a would-be buyer or seller is seeking to improve his own expected welfare and is not adversely affecting anyone else's. In thin markets, where counterparties at a "fair" price are hard to find, one's willingness to buy or sell may create positive externalities for others by enabling them to transact more easily at such a price. Thus, unless there is more to the story, tax-penalizing sales is hard to rationalize.
- Realization-based income taxes already discourage sales of appreciated assets, which may yield taxable gain to the seller that could otherwise be deferred or even permanently avoided. Accordingly, if taxing sales is undesirable, an STT does not merely start from zero in undesirably discouraging them, but may actually worsen preexisting distortions for appreciated assets. (On the other hand, the STT may offset inefficient income tax encouragement of sales of loss assets.)
- Depending on their design, STTs risk being highly avoidable in at least two ways. The first is location. If there is an STT on sales in Country X but not on those in Country Y, taxpayers may find it a lot easier to change the sale location than to change more meaningful choices such as where individuals live or where tangible business activity occurs. Sweden recently learned that the hard way when its FTT, within a four-year period, induced more than half of all domestic securities trading to move to London.[32]
- The second way in which an STT is potentially highly avoidable concerns the rules for defining both specific financial instruments and taxable transactions such as sales. Now that transactions using derivatives have become common — for example, through the use of swaps that depend on the performance of Siemens stock in lieu of buying or selling that stock — an STT is unlikely to be very effective unless the taxation of derivative transactions is adequately aligned with that of the "primary" transactions they may replace.

To illustrate, suppose that in the absence of an STT, I would borrow $10 million and use the funds to buy Siemens stock. If the STT only applied to literal sales, I could avoid it, while replicating the economics of this transaction as follows. Presumably with a financial firm like a bank as my counterparty, I could simply arrange a swap based on a notional principal amount (NPA) of $10 million. On

[30]*See* Tobin, "A Proposal for International Monetary Reform," *supra* note 8, at 158.

[31]*See generally* Peter A. Diamond and James A. Mirrlees, "Optimal Taxation and Public Production: I — Production Efficiency," 61(1) *Am. Econ. Rev.* 8 (1971).

[32]Marion G. Wrobel, "Financial Transaction Taxes: The International Experience and the Lessons for Canada," Parliament of Canada (1996).

the transaction date, no cash would change hands (leaving aside the likelihood that the counterparty would insist on my posting collateral to secure my potential liability under the swap). On the swap settlement date, I would owe the bank an amount equal to the interest that I would have owed on an actual $10 million loan during the swap term. The bank would owe me the dividends and appreciation that $10 million of Siemens stock would have yielded during the swap term. Accordingly, I would end up in exactly the same position (leaving aside transaction cost differences) as if I had actually made a debt-financed purchase of $10 million of Siemens stock, yet there would not have been an actual (or at least literal) sale:

- STTs, like income and wealth taxes but unlike consumption taxes such as VATs, discourage investment and saving. They are thus subject to the same critique as income taxes for creating needless distortion without necessarily making possible greater progressivity.[33] However, even if one favors taxing investment and saving, it is unclear (barring rationales such as those advanced by Keynes and Tobin) why one would favor this particular mechanism, rather than one like a wealth tax or an income tax, which depends on the amount saved or the return to saving rather than on the gross amounts involved in sale transactions.
- STTs can be expected to increase the cost of capital when firms seek to raise funds by issuing tradable securities. Even if the initial issuance is not taxed, investors may well anticipate that the tax will affect resale prices.

C. The European Commission's FTT

The commission's FTT clearly was "designed with an eye to [addressing] known weaknesses in FTTs by ensuring that its scope is broad along a number of dimensions."[34] However, breadth intended to address avoidability is only one of the two main design principles that one can infer by examining the commission proposal's main features. The other is attempting to create both the appearance and the reality of a tax that falls on the "financial sector" — a term that, as I will discuss in Part III, requires a bit of unpacking — while ostensibly ensuring that households and small to medium-size business enterprises will "hardly be affected."[35]

1. Addressing avoidability. The commission's STT broadly defines covered financial transactions to include not only the trading of equity and commercial debt, but also the "conclusion or modification of derivatives agreements" and the "purchase/sale or transfer of structured products" along with securitizations.[36] The proposal uses a broad definition of financial institutions, which must be involved in a transaction in order for the tax to apply. The covered institutions include not just conventional banks (other than the European Central Bank and national central banks, which are exempted), but also "investment firms, organized markets, credit institutions, insurance and reinsurance undertakings, collective investment undertakings and their managers, pension funds and their managers, holding companies, financial leasing companies, special purpose entities . . . and other persons carrying out certain financial activities on a significant basis."[37]

Among the proposal's most notable features is its use of residence-based jurisdiction. Past FTTs, like the one that worked out so poorly for Sweden in the 1980s, have typically applied to transactions that were executed domestically — meaning that all one had to do to avoid them was move the place of sale abroad. The commission's STT, by contrast, would apply on a residence basis. Thus, if any party to a financial transaction is "established in the territory of a Member State," the tax applies. Such establishment is itself defined broadly. It includes not only financial institutions that are registered in an EU country or are authorized to act (say, as banks) there or that have headquarters in an EU country, but also firms that otherwise would be treated as foreign but that have a branch in an EU country. However, EU residence for purposes of the FTT apparently does not extend to foreign firms that have separately incorporated EU resident subsidiaries but choose to transact through other affiliates.

EU resident financial institutions, as defined under the proposal, generally would face the tax no matter where a transaction was executed.[38] Moreover, if an EU resident (such as an individual)

[33]*See, e.g.*, Daniel N. Shaviro, "Replacing the Income Tax With a Progressive Consumption Tax," *Tax Notes*, Apr. 5, 2004, p. 91, *Doc 2004-6003*, or *2004 TNT 66-48*; Joseph Bankman and David A. Weisbach, "The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax," 58 *Stan. L. Rev.* 1413-1456 (2006); Shaviro, "Beyond the Pro-Consumption Tax Consensus," 60 *Stan. L. Rev.* 745-788 (2007).

[34]John Vella et al., "The EU Commission's Proposal for a Financial Transaction Tax," *Brit. Tax Rev.* No. 6, 607 (2011).

[35]European Commission, "Explanatory Memorandum: Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC," article 5 (Sept. 2011).

[36]*Id.* at article 3.3.1.

[37]*Id.*

[38]The council directive states, however, that "in case the person liable to pay the tax was able to prove that there is no

(Footnote continued on next page.)

participates in a financial transaction that exclusively uses non-EU financial institutions, those institutions will be treated as residents for purposes of the transaction and thus will have to pay the tax.[39]

A follow-up draft report by the Committee on Economic and Monetary Affairs of the European Parliament extends the FTT's proposed reach so that it also applies to any transaction that ''involves a financial instrument issue by legal entities registered in the Union.''[40] Thus, if an American stockbroker sells Siemens stock to an American investor on the New York Stock Exchange, at least ostensibly the transaction is subject to the EU's FTT. Likewise, if non-Europeans use derivatives, such as a swap, in which one of the party's payments is computed with reference to stock in a company that is incorporated in Europe, the FTT likewise ostensibly applies. In either case, however, collection of the tax appears unlikely.

Ignoring the enforcement problems that may be associated with requiring tax remittance by financial institutions that operate outside the EU, the stated breadth of application could indeed reduce the tax's avoidability. However, one would expect non-EU persons to react by shifting away from the use of EU financial institutions to execute their deals. Thus, for example, U.K. banks that compete with rivals in the United States and Hong Kong to attract business from non-EU individuals will presumably find themselves at a disadvantage. Also, the ability of multinational corporate entities to avoid the tax by using their non-EU rather than their EU-based affiliates to conduct transactions may prove to be a significant gap.[41]

One of the trickier questions posed by the proposal is how to determine the taxable amount in a transaction using derivatives. For a sale of $10 million worth of equity, the taxable amount is of course $10 million, to which a 0.1 percent tax (that is, $10,000) is supposed to apply to each taxpayer.[42] However, since (as discussed below) transactions between entities that are members of the same corporate group are subject to the STT, in those cases transfer pricing issues will arise. With derivatives, however, determining the taxable amount is not so easy.

Suppose that two parties effectively did the $10 million swap involving Siemens equity that I described above. Unsurprisingly, the taxable amount would be the $10 million NPA.[43] The commission recognizes, however, that things will not always be this simple: ''For example . . . the notional amount of a swap could . . . be divided by an arbitrarily large factor and all payments multiplied by the same factor.''[44] In the above case, that might involve an NPA of $1 million and requiring each party to pay at 10 times the rates used in the preceding example. That type of problem would be dealt with using undetermined ''special provisions.''[45]

Without presuming to anticipate all the ways in which sophisticated financial engineers could package economic returns that effectively depend on the performance of $10 million of Siemens stock (or something that is correlated with it), one can be confident that many possibilities will present themselves. And in a world where the same financial bet can be expressed in so many ways,[46] often it may be impossible to identify or even define the ''true'' underlying financial transaction.

The commission's proposed response to that problem is twofold. First, when ''more than one notional amount is identified, the highest amount shall be used for the purpose of determining the taxable amount.''[47] The standards for determining the list of possible NPAs remain to be considered. Second, presumably to respond to the concern that that might result in unduly tax-disfavoring derivative transactions that could be decomposed in multiple ways, the tax rate for those transactions is only 0.01 percent,[48] or one-tenth that which otherwise applies. Presumably, that means the tax on the sale of $10 million in Siemens stock can be reduced from $10,000 to $1,000 by replacing it with the swap.[49]

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link between the economic substance of the transaction and the territory of any Member State,'' the tax may not apply. *Id.* at article 3.3.1.

[39]*Id.*

[40]*See* Committee on Economic and Monetary Affairs, *supra* note 3, at 10.

[41]*See* Vella et al., *supra* note 34, at 4.

[42]*See* European Commission, ''Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC,'' article 8 (Sept. 2011).

[43]*See* European Commission, *supra* note 35, at section 3.3.2.

[44]*Id.*

[45]*Id.*

[46]Consider, for example, the put-call parity theorem, which ''states that given any three of the four following financial instruments — a zero-coupon bond, a share of stock, a call option ('call') on the stock, and a put option ('put') on the stock — the fourth instrument can be replicated.'' Michael S. Knoll, ''The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage,'' 87 *Ore. L. Rev.* 93, 95 (2008).

[47]European Commission, *supra* note 35, at article 6.

[48]*Id.* at article 8.

[49]However, that assumes that the swap is not characterized for STT purposes as instead of or even also a sale. *See* European Commission, *supra* note 35, at article 3.3.1 (''The scope of the tax . . . is also not limited to the transfer of ownership but rather represents the obligation entered into, mirroring whether or not

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The Committee on Economic and Monetary Affairs of the European Parliament, in a draft report amending the original commission proposal, explains the lower tax rate for derivative transactions as follows: ''In the case of derivatives, the estimation of their value being much more difficult, the decision to opt for the notional value — which can be significantly higher than the real market value of a derivative — justifies the choice of a lower rate.''[50] However, that does not entirely make sense. Consider the swap described that involved $10 million in Siemens stock versus the interest on $10 million. In principle, each side of that swap should initially be worth zero. However, that is a net, rather than gross, value measure, and net value generally is irrelevant under the FTT. After all, a wholly debt-financed explicit purchase of $10 million in Siemens stock also has a net value of zero, and yet would be taxed as a $10 million transaction.

The committee may have in mind that often when parties enter into derivative transactions, they may not be seeking to substitute for deals that would have involved the full NPA. Instead, they may be seeking to hedge particular economic risks cheaply, such as by paying a modest premium for a position that has a positive expected (although contingent) payout. In that setting, charging the full ''normal'' tax rate based on a given NPA might be viewed as imposing very high effective tax rates on the ''true'' underlying transactions. Unfortunately, however, the fact that similar-looking derivative transactions may actually be substitutes for very different ''primary'' transactions makes it extremely difficult for an FTT to replicate the tax burdens that might have been deemed appropriate if derivatives did not exist.[51]

2. Seeking to direct tax burdens to the financial sector. The commission's goal of directing both actual and perceived tax burdens to the financial sector could not have been accomplished simply by making financial firms the only parties that remit STT payments. After all, only businesses must remit VAT payments to the tax authorities, yet VATs are widely understood as taxing households based on their consumption. However, two further sets of design features appear to reflect the commission's stated distributional aim. The first concerns exclusions from the reach of the proposed FTT, while the second concerns what might be regarded as a surprising category of inclusions.

As noted above, the proposal exempts spot currency transactions, thus preserving the free movement of capital.[52] Also, consistent with the aim of keeping citizens and business outside the scope of the FTT, it excludes the primary issuance of debt and equity securities. It is unclear how broadly that exclusion applies, such as when the underwriters in an initial public offering take on a lot of new stock before deciding how much of it they plan to sell promptly. However, even with a broadly defined exclusion for securities sales that are related to primary issuance, the tax would be expected to impose a burden on that issuance, since the amount that primary purchasers are willing to pay presumably will reflect the prospect of a future tax on resale.

Also exempted, presumably to limit the tax burdens directly imposed on households, are ''insurance contracts, mortgage lending, consumer credits, payment services, etc.''[53] One wonders if creative tax planners could use those exclusions to avoid the reach of the FTT. Consider, for example, that credit default swaps are economically akin to insurance, because they offer the holder a payoff if the debtor fails to pay. Could insurance-like financial products that financial institutions and their customers trade, and that the proposal presumably is intended to reach, therefore be designed to escape the STT? That might require the cooperation of an EU host country if, in applying the exclusion, insurance is defined in terms of being subject to conventional national insurance regulation. But a country that decided to cooperate with aggressive tax planners might view itself as benefiting from the opportunity to attract transactions and business. In effect, it would be engaging in tax competition with the rest of the EU by not actually levying the same tax as other countries, even if it appears to be doing so.

This brings us to the perhaps surprising inclusions. If two or more EU resident financial institutions participate in a transaction, each is fully taxable. Thus, if one European bank sold €10 million in Siemens stock to another, apparently each would pay €10,000 of tax. More complicated transactions with, say, 10 financial industry participants

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the financial institution involved also assumes the risk implied by a given financial instrument ('purchase and sale')'').

[50]Committee on Economic and Monetary Affairs, *supra* note 3, at 18.

[51]The FTT variant recently proposed in the United States approaches derivatives differently than the FTT proposal. While treating the issuance of a derivative as taxable, the U.S. proposal makes no effort to determine NPAs, and instead simply applies its general 0.03 percent rate to the fair market value of (and payments made under) derivative instruments. *See* S. 1787 and H.R. 3313, *supra* note 2, at proposed section 4475(b), (e)(1)(D) through (F), and (h). In cases like the above-described Siemens swap, the proposed U.S. version therefore would permit taxpayers to greatly lower their FTT liabilities by substituting derivatives transactions for ''actual'' ones.

[52]European Commission, *supra* note 35, article 3.3.1.

[53]*Id.*

would lead to the imposition of 10 taxes. Even in a relatively simple deal, that could matter a lot. Suppose I sell Siemens stock to you (we are both EU residents), and each of us uses a broker. Will three taxes be imposed, rather than one, if I first transfer the stock to my broker, who then transfers it to your broker, as intermediate stages in the transaction?[54]

Moreover, the rule taxing all financial industry participants applies not just to arm's-length deals between unrelated firms, but also to transactions taking place between entities of a group[55] — perhaps including distinct branches, like those in different countries, rather than just separately incorporated affiliates. The proposed FTT would therefore create cascading taxes within the financial sector that could not be avoided through common ownership. That is a design virtue in one sense, because it avoids creating inefficient tax incentives for consolidation. But it is a vice in another sense because it strengthens the presumably inefficient cascading tax.

D. The FAT Variants Discussed by the IMF Staff

I now turn to the alternative of enacting a FAT instead of an FTT. Purely on the level of rhetoric, it is difficult to imagine a question that initially sounds as tedious as whether we should tax financial transactions or activities, and thus endorse the F-blank-T acronym with the T or the A in the middle. In fact, the key element of the choice between the two taxes can be presented a lot more concisely than that. An FTT targets the gross proceeds, while a FAT targets some variant of the net proceeds (that is, the gross proceeds minus specified cash outlays) that financial firms generate through their business activities.

Suppose we were evaluating that tax design choice for the food industry, rather than financial institutions. Then the question would be whether retail stores, wholesalers, farmers, and the like should be taxed on their gross sales proceeds (including those arising from transactions between separate entities within the food industry)[56] or only on some net measure of industrywide profits or value added. We should keep in mind, however, that this is a question of tax design, not of whether taxes should be higher or lower. While the gross proceeds tax would nominally have a much larger tax base, it presumably would use a much lower statutory rate if the two alternatives were meant to impose the same overall burden on the industry or to raise the same amount of revenue.

While a gross proceeds tax on the food industry may appear bizarre,[57] it should help to make more intuitive the key difference between an FTT and a FAT. An FTT targets a transactional measure of overall gross activity in the financial sector; a FAT, the profits or — in an accounting if not a social sense — its value added.

What might a FAT look like? Here we again encounter the Gertrude Stein issue that I noted at the start. That is, the answer depends on the question, which initially is why one would consider imposing a profits tax that is particular to the financial sector. After all, income taxes generally apply to all industries (although as we will see, they define the profit concept differently than do the FAT variants that have recently been discussed).

In that regard, it is best to go to the source. Contemporary discussion of the FAT, including its acronym and name, dates from an important publication by the IMF staff, published in June 2010 in response to a request from the G-20 leaders that the IMF describe a "range of options . . . as to how the financial sector could make a fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system."[58] The report argues that an FTT "does not appear well suited to the specific purposes set out in the mandate from G-20 leaders."[59] It therefore advances three alternative FAT variants, each with a distinct design reflecting particular purposes.

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[54]In a letter directed to clients, the British law firm Clifford Chance describes what it views as a common scenario in which a simple stock sale might lead to the imposition of six, rather than just three, taxes. *See* Clifford Chance, "Financial Transaction Tax: Update," (2011), *available at* http://www.cliffordchance.com/publicationviews/publications/2011/10/financial_transactiontaxupdate.html.

[55]*See* European Commission, *supra* note 35, at article 3.3.1.

[56]If transactions between food industry entities were not taxed, then the tax on its gross sales proceeds from transactions outside the sector would cause it to resemble a retail sales tax just on the food industry. The main difference would be its reaching food sales that were production inputs to other industries, rather than just sales made directly to consumers.

[57]However, one could imagine there being plausible motivations for a gross proceeds tax on the food industry. Suppose the industry imposed negative externalities — relating to its environmental effects or to the publicly borne healthcare costs resulting from obesity or poor diets — and that no more direct measure of the harm being caused than sectorwide transactional activity was available. In that scenario, one would want to impose taxes to compensate for the externalities even if the food sector was merely breaking even. In the absence of a better proxy, the gross proceeds tax might be worth considering despite its undesirable imposition of a cascading tax on transactions within the food industry.

[58]IMF staff, *supra* note 5, at 4.

[59]*Id.* at 19. The report offers three reasons for considering the FTT ill suited to the G-20 leaders' mandate: (1) the volume of financial transactions is not a good proxy for the firm-level benefits and societal costs resulting from the prospect of financial firm bailouts; (2) the FTT "would not target any of the key

(Footnote continued on next page.)

The IMF's three models, which it calls FAT-1, FAT-2, and FAT-3, are not wholly distinct choices, like doors 1 through 3 in the famous TV game show *Let's Make a Deal*. Rather, they relate to each other like Matryoshka dolls, one nested inside another. FAT-1 is the broadest, while FAT-2 and FAT-3 use narrower bases so that they can target particular elements of the FAT-1 base that it would include nondistinctively.

1. FAT-1. This is essentially a special or modified VAT on the financial sector. To explain it, we will start from a standard VAT, which is a tax on "sales of real goods and services less purchases of nonlabor inputs."[60] Thus, a grocery store would include all of its proceeds from sales to consumers, while effectively deducting (in the form of a credit that would be computed at the VAT rate) its outlays to other VAT-paying businesses. However, the wages that it paid would not be deducted — reflecting that its workers, unlike the businesses to which it made deductible payments, would not face VAT liability on the amounts received. Likewise, financial flows, such as interest payments that the grocery store made to banks that had helped fund its operations, would neither be deducted by the store nor included by the banks.

The VAT, given that it taxes "value added" in the sense of sales minus purchases without regard to wages or financial flows, is "implicitly a tax on the sum of wages and 'profits' defined in cash flow terms (that is, with full expensing of investment and no deduction for financial costs)."[61] Profits in that sense refers to returns in excess of the normal rate of return on investment, which effectively is exempted by allowing the business's capital outlays to be expensed.

VATs normally do not apply to financial sector firms, reflecting that financial flows, such as interest payments, generally are excluded from it. The FAT-1, however, is designed to extend to the financial sector the basic VAT concept of taxing the sum of its wages and profits in the above sense.[62] Despite the conceptual overlap, however, the FAT-1 not only requires a different method than a plain-vanilla VAT, but (as we will see) is rationalized differently.

Why do VATs — along with retail sales taxes (RSTs), which many U.S. states and localities impose — generally ignore financial cash flows, like interest payments on a loan? In the business sector, the combination of exclusion on the lender side and nondeductibility on the borrower side has zero net impact if the tax rates for borrowers and lenders are the same. For example, if Siemens pays Deutsche Bank $10,000 of interest and both pay tax at a 25 percent rate, the net tax revenue produced from bringing that cash flow within the reach of the German VAT would be zero: Deutsche Bank's $2,500 tax liability would be offset by Siemens's $2,500 tax recoupment.[63] Exempting that interbusiness transaction is a wash.

But what about the fact that for VAT purposes, Deutsche Bank does not merely get to ignore financial flows in computing its liability, but is entirely tax exempt? If all that Deutsche Bank did was engage in interbusiness transactions, the VAT exemption would raise revenue. After all, if Deutsche Bank were a full-fledged VAT taxpayer, then in addition to paying tax and getting credits for financial cash flows that (net of the effects on business counterparties) are a wash, it would also get refunds or credits for purchasing nonfinancial inputs like buildings and desks. In sum, VAT exemption is a detriment, rather than a benefit, to financial firms insofar as they are purely engaged in business-to-business transactions.

But why doesn't the VAT apply to transactions between financial (and other business) firms and households? Suppose I pay interest on a vacation loan to a bank, which would lead to VAT liability if I had been paying for the vacation itself. Here the problem is that imposing the VAT on interest flows between businesses and consumers would raise the question of what a consumer is. At least from the normative standpoint that underlies support for consumption taxes like the VAT, one could argue that no one is really a consumer by reason of saving (or dissaving) and thereby earning a positive (or negative) financial return. After all, earning or paying interest is not itself an act of consumption,

attributes — institution size, interconnectedness, and substitutability — that give rise to systemic risk" potentially necessitating bailout; and (3) the real incidence of the tax might fall on consumers, rather than on earnings in the financial sector. *Id.* at 19-20.

[60] *Id.* at 66.

[61] *Id.*

[62] *See id.* (stating that "it would be appropriate" to design the FAT-1 similarly to the basic VAT concept).

[63] Because after-tax interest rates presumably reflect supply and demand, one might further expect nominal or pretax interest rates to adjust to the choice of tax rule, such that at equilibrium, Siemens and Deutsche Bank, and not just the tax authorities, would end up in the same after-tax position either way. The main reason an income tax, unlike a consumption tax such as a VAT, cannot so readily ignore interbusiness interest flows even if all parties tax rates' are the same is that the borrower's interest expense may need to be capitalized rather than deducted — for example, if it contributes to creating a durable asset. Thus, interbusiness interest flows may yield net tax revenue in an income tax system that would be overlooked if they were ignored.

and consumption taxes typically are neutral regarding the timing of consumption, a goal that generally requires ignoring time-value-based returns to saving.[64]

If the financial sector served simply as an uncompensated middleman between households that were borrowers and those that were savers, handing along interest payments from the former to the latter without getting paid for it, then the VAT exclusion for financial transactions would still be immaterial. After all, as an uncompensated middleman, the sector would have neither wages nor profits. But of course that is not the case. Even the simplest community bank generally charges a higher interest rate on loans than it offers on savings deposits, not just because of default risk, but also because of the services it renders in its middleman role. In effect, it is bundling its service fee with the interest charge that one might naively have thought merely reflected the time value of money.

Even that bundling might not matter if we believed that households' financial transactions have zero consumption content. But that characterization would be highly questionable. Suppose I have a choice between saving with two banks. The first one offers free checking and free ATM use but pays me a low interest rate. The second charges me for both services, but offers me a higher interest rate. There is a powerful argument that the convenience of being able to write checks and get money from an ATM contributes to my consumption.[65]

If banks charged separately stated fees for all services provided that offered consumption value to the purchasers, it would be conceptually simple to subject those fees to the VAT, without permitting the payer to deduct or credit them. But with bundling plus the difficulty of identifying the consumption component of using financial services, real-world VATs (as well as RSTs) have generally settled for simply exempting the financial sector. Thus, they get a VAT subsidy insofar as consumer transactions are concerned, and an overall or net subsidy if that tax benefit outweighs the detriment from exempting business-to-business transactions.[66]

Less widely recognized is the fact that financial firms may get a similar tax subsidy for consumer transactions under the income tax. That subsidy results from their ability to give their customers implicit deductibility for consumer fees, such as for the personal convenience of using checks and ATMs, by using bundling in the form of offering what would otherwise be below-market interest on the money deposited in checking and savings accounts. Tax experts often ignore that point, perhaps because they are unduly fixated on whether financial firms are expressly tax exempt (even though VAT exemption is a detriment for business-to-business transactions). In practice, it is plausible that the net income tax subsidy to the financial sector exceeds that under the VAT, assuming similar rates under the two taxes, given that financial firms can deduct (or at least capitalize) their outlays for nonfinancial inputs. Thus, the common focus on the VAT as the main source of subsidies may be misguided.

With all that in mind, let's return to the FAT-1, which seeks to impose a VAT-like tax on financial sector wages and profits. How does one accomplish that technically, given the bundling problem? One way would be to require that financial sector firms include and deduct all cash flows, such as interest payments but also loan principal, rather than just (as with VATs and RSTs) including cash flows from transactions that involve "real" rather than financial goods and services.[67] That would prevent bundling from affecting financial firms' FAT-1 liability, since the same tax would apply regardless of the choice between financial and nonfinancial labels on cash flows. For convenience, I will call this the cash flow tax version of FAT-1.

However, one could also implement the FAT-1 by using a tax base for financial firms that was somewhat like a broad-based corporate income tax, such as in how it ignores flows of loan principal, but with the following adjustments: (a) wage nondeductibility; (b) expensing for all outlays to other businesses, including those that would be capitalized under the income tax; and (c) the allowance of an interestlike deduction for the taxpayer's equity. Providing an interestlike deduction for equity that reflected the normal rate of return would ensure that only profits above that rate of return, plus the amount of the financial sector's wages, would remain in the tax base. I will call this the allowance for corporate equity (ACE) version of the FAT-1.

One could further modify the ACE version of the FAT-1 by having a notional time value of money deduction apply to corporate debt as well as equity,

[64] *See* Shaviro, "Replacing the Income Tax With a Progressive Consumption Tax," *supra* note 33, at 104.

[65] The point is better described as relating to the value of untaxed leisure. The convenience of being able to write checks and get money from ATMs increases my opportunities to derive untaxed imputed income from enjoying leisure.

[66] A recent study by a major accounting firm argues that banks' tax exemption under EU VATs actually disadvantages them on balance, because of the business-to-business issue. *See* PricewaterhouseCoopers LLP, "How the EU VAT Exemptions Impact the Banking Sector" (2011).

[67] IMF staff, *supra* note 5, at 66.

in lieu of providing deductions for actual interest paid or accrued. (However, for banks that paid below-market interest, such as on retail checking and savings accounts, one would need to limit the deduction to the amount actually paid, as a device for indirectly including the offsetting implicit service fees.) For financial instruments that paid more than the notional time value of money, that would make the distinction between debt and equity, and thus the question whether a given payment to financial instrument holders constituted interest or a dividend, irrelevant for purposes of applying the FAT-1. I will call this the allowance for corporate capital (ACC) version of the FAT-1.

No matter which of those versions is used, there is an important respect in which the FAT-1 would *not* merely result in effectively extending the VAT to financial firms. Assuming that nonfinancial firms did not get a refund (under either the VAT or the FAT-1) for their payments to financial firms, the FAT-1 would impose a net tax on interbusiness transactions. As the IMF staff report makes clear, the rationale for that — leaving aside the issue of untaxed personal consumption from financial transactions — would be to extract from the financial sector a ''fair and substantial contribution toward paying for any burden associated with government interventions to repair the banking system.''[68] In effect, the idea is that the detriment of overtaxing — or indeed increasing existing VAT overtaxation of — business-to-business financial services is outweighed by the benefit of addressing VAT (and income tax) undertaxation of business-to-consumer financial services. The report proposes that concern about cascading tax liabilities on interbusiness transactions be addressed by charging the FAT at lower than the generally prevailing VAT rate in order to limit the damage.[69]

One problem with the FAT-1, however, is that besides not directly targeting the behavior that gives rise to the possibility of bailout, it also only imperfectly offsets business-to-consumer undertaxation (given the business-to-business overtaxation problem). Accordingly, even if its rate was set so as to raise exactly the right ''excess'' amount of revenue from the financial sector as a whole (that is, relative to simply offsetting the sector's VAT and income tax subsidies), liability under the FAT-1 would be misallocated.[70]

Thus, the FAT-1 is certainly not a first-best financing mechanism for requiring a ''fair and substantial contribution'' from the financial sector. The case for it would have to rely on one's inability to do better in targeting VAT and income tax gaps and the creation of bailout risk. The case for using the FAT-2 or the FAT-3, in lieu of the FAT-1, rests on the possibility that by narrowing the base in a targeted way, one could lower the general efficiency costs or better address the bailout risk problem.

2. FAT-2. The FAT-2 takes on that challenge as follows. Suppose we want to charge the financial sector for expected bailout costs plus the value of its VAT and income tax subsidies (via the effective exclusion of consumer services), but that we cannot do so in a first-best fashion by directly taxing the things that we have in mind. We might be reassured if we could design the tax to create as little inefficiency as possible.

From that standpoint, consider the idea of taxing what economists call rents. As I have explained elsewhere:

> In lay terminology, rents are what you pay your landlord each month. Economists, however, use the term to denote ''payments to resource deliverers that exceed those necessary to employ the resource.'' . . . An example would be Michael Jordan, back in the day, when he could earn $30 million per year playing basketball and no more than, say, $100,000 doing anything else with his time. The existence of this $29.9 million excess of what Jordan could earn by playing basketball over the next best use of his time potentially has an important tax policy implication. If he planned to work [with the same intensity] in any event, at whatever occupation paid him the most, one could tax away all of the extra return (leaving only, say, an extra cent) and he still would play basketball rather than doing anything else. A very high tax would therefore result in no economic distortion of behavior, contrary to what one normally expects.[71]

The FAT-2 reflects the premise that it would therefore be highly efficient to tax financial sector rents. To be sure, that is equally true for rents derived outside the financial sector. However, nonfinancial sector rents already are subject to VAT in most countries, and in any case the IMF staff was specifically tasked with exploring how taxes might be increased on the financial sector. What is more, the staggering growth of the sector's profits and high-end compensation over the last two decades

[68]*Id.* at 4.

[69]*Id.* at 67.

[70]Several countries, like Denmark, France, and Italy, have taxes that at least resemble the FAT-1 by applying to the payroll of financial sector firms or of VAT-exempt firms generally.

[71]Shaviro, *Decoding the U.S. Corporate Tax* 22 (2009).

has prompted the widespread belief that rents are rife here.[72] Indeed, a recent paper estimated that in recent years, rents have accounted for between 30 and 50 percent of the wage differential between the financial sector and other sectors in the economy.[73]

How does one design a tax on financial sector rents with the FAT-1 as the starting point? Recall that as a VAT-like instrument, it is a tax on the ''sum of [financial sector] wages and 'profits' defined in cash flow terms.''[74] Suppose we change the FAT-1 tax base (whether in the cash flow tax, ACE, or ACC version) by making wages deductible. Then, transition issues aside,[75] you have a tax just on profits, defined in cash flow terms — that is, on extra-normal rates of return. While those can arise in practice even without an expected above-normal rate of return, when the taxpayer ends up winning a risky bet, suppose that risky outcomes even out in the long run (and that taxpayers can effectively average out their high and low rate of return years, for purposes of the tax). Then what remains is a tax on truly above-normal rates of return — that is, on rents. So the FAT-2 could seemingly be narrowed into a tax on financial sector rents (rather than rents plus wages) simply by modifying it to treat all wages as deductible.

However, modifying the FAT-1 by making all wages deductible would create two problems. First, owners of financial sector firms that were generating extra-normal profits could remove those profits from the FAT tax base simply by paying the money to themselves as wages. Second, high-end wages to financial sector employees (whether they are owners or not) may themselves represent the very rents that we want to tax. Accordingly, the proposed FAT-2 would not permit all wages to be deducted. Instead, it would allow deductions only for some measure of ''ordinary'' wages, such as those paid to rank-and-file workers, that are thought not to reflect the payout of financial sector rents.

The IMF staff report concedes that identifying labor rents ''is extremely difficult in practice, [suggesting] that a pragmatic approach would need to be adopted. That might be done, for instance, by comparing the earnings of top earners in the financial sector with those of top earners in other sectors.''[76] In effect, deductions for wages paid to highly compensated employees would be limited to some measure of what it was thought that people with similar qualifications (such as education levels) working with similar intensity in other professions typically were earning. Thus, roughly speaking, FAT-2 wage deductions for paying compensation to investment bankers might be limited to the levels that were attributed, say, to similarly experienced lawyers.[77]

3. FAT-3. A focus on financial sector rents prompts one to ask why they have apparently been so high in recent decades. Several explanations are possible. For example, financial sector rents may reflect barriers to entry in the rarefied world of high-end finance, or they may result from financial firms' use of opacity to confuse and dupe customers about the value of particular financial products and the prices for and availability of economically comparable products.

A further possibility, however, is that financial sector profits often reflect fake rents rather than actual ones, in the same sense that I could generate ''rents'' from playing roulette at the casino if I could bet someone else's chips, pocketing all the winnings when the ball landed on red but not having to pay for the chips when it landed on black. That resembles what financial firms increasingly did in the years leading up to the 2008 financial crisis. Through means such as the placing of highly leveraged bets on appreciating assets like real estate and stocks, the firms widely followed '''nickels in front of a steamroller' strategies, under which one earns extra-normal returns most of the time but occasionally experiences dramatic losses.''[78] The bets were effectively ''heads I win, tails you lose'' in character, given that if the downside tail risk eventuated (such as via declining stock or real estate prices), people other than the financial sector bettors themselves — either the taxpayers who paid for bailouts, or everyone who was hurt by a resulting macroeconomic downturn — would bear enormous losses.[79]

Countering financial firms' socially dangerous incentive to place ''heads I win, tails you lose'' bets

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[72]*See, e.g.*, John Cassidy, ''What Good Is Wall Street?'' *The New Yorker*, Nov. 29, 2010, *available at* http://www.newyorker.com/reporting/2010/11/29/101129fa_fact_cassidy.

[73]Thomas Philippon and Ariell Reshef, ''Wages and Human Capital in the U.S. Financial Industry: 1909-2006,'' National Bureau of Economic Research working paper 14644 (2009), at 2.

[74]IMF staff, *supra* note 5, at 66.

[75]In addition to taxing rents, the FAT-2 (as well as the FAT-1) could result in taxing old capital that was on hand when the tax first began to apply. Old capital may return positive cash flows that either FAT reaches, without cost recovery if that is limited to new (*i.e.*, post-effective date) capital.

[76]IMF staff, *supra* note 5, at 68.

[77]Iceland recently enacted a FAT-2, with a tax rate of 5.45 percent.

[78]Douglas A. Shackelford, Daniel Shaviro, and Joel Slemrod, ''Taxation and the Financial Sector,'' 63 *Nat'l Tax J.* 781, 787 (2010).

[79]Shaviro, ''The 2008 Financial Crisis: Implications for Income Tax Reform,'' NYU Law School, NYU Center for Law, Economics, and Organization, working paper 09-35 (2009), at 13. Also, financial sector employees with incentive compensation may have made ''heads I win, tails you lose'' bets in which shareholders bore a significant downside. *See id.*

is primarily the job of financial regulatory policy, as well as of bank taxes (such as those explicitly financing bailout or resolution funds) that depend on some measure of the systemic risk that an actor or set of actions appears to pose. However, the FAT-3 operates from the premise that those rules will be imperfect and that the mechanism for extracting a ''fair and substantial contribution'' from the financial sector can contribute at this level as well.

To that end, the IMF staff proposes modifying the FAT-2 tax base so that rather than reaching all profits, as defined relative to the normal rate of return, it would tax only very high profit rates.[80] The premise would be that those extra-high profits are indirect evidence of tail risk that the bettor is not bearing. Accordingly, under the FAT-3, the cost of capital deduction, as computed under an ACE or ACC approach, might be 15 percent, rather than something that (depending on actual market interest rates) might well be only one-fifth to one-third as great.

That alone would do nothing to focus the tax's impact on risky bets, which depends instead on the distinct issue of refundability when a financial sector firm falls short of achieving a taxable return. To make this point more clearly, we will first return to the FAT-1 in its cash flow version. If positive net cash flows (as defined under its rules) are taxable, then presumably — reflecting common practice under existing VATs — negative net cash flows would be refundable. Thus, under a 10 percent FAT-1, if a firm with $1 million in net cash flows (as computed under the system's rules) would pay tax of $100,000, then one with a net cash flow of negative $1 million would receive $100,000. That would cause the FAT-1 to apply symmetrically to taxpayer bets that could either win or lose, reflecting that risk discouragement is not among its goals.[81]

Now suppose that we switch to the ACE (or ACC) version of the FAT-1, under which flows of loan principal are ignored, but a cost of capital deduction is allowed for corporate equity (or all firm capital). Presumably, refundability would apply with regard to cost of capital deductions no less than actual negative cash flows, given the lack of any change in the tax's scope. That presumably would continue to hold if we switch to the FAT-2. After all, merely because one is allowing ''ordinary'' wage deductions in order to focus the tax on rents does not imply departing from the FAT-1's neutrality as between risky investments and those that have a relatively fixed expected positive return.

What makes the FAT-3 different in that regard is not increasing the tax-free rate of return to a much higher level, like 15 percent, but eliminating the tax's gain-loss symmetry, or more generally its linear rate structure. Note that the FAT-3 surely would not provide a refund to financial firms earning less than the tax-free rate of return. Thus, suppose that under a FAT-3 with a tax rate of 20 percent, a financial firm has corporate equity of $100,000 and net cash flow (as computed for FAT-3 purposes, with only ordinary wages being deducted) of either (a) $40,000 or (b) zero. If the tax-free rate of return was 15 percent, leading to an exempt return deduction in the amount of $15,000, then under (a) the firm would pay tax of $5,000, but under (b) it presumably would not get any refund.[82] Otherwise, the FAT-3 would turn into a subsidy for financial firms that earned merely normal returns.

To achieve the FAT-3's goal of discouraging risk taking, on the view that high observed profit rates of financial firms are associated with hidden tail risk that implies loss externalization, all one needs is some version of that gain-loss asymmetry (or more generally, having a nonlinear tax rate that rises in some fashion with the ex post rate of return). Making financial firms' profits tax free until they reach the ''extraordinary'' (such as 15 percent) level seems unnecessary, and it means that some rents would escape the tax even though the logic underlying the FAT-2 is in no way refuted by positing that there is also a ''fake rents'' problem of the sort targeted by the FAT-3. I would therefore advocate doing less to narrow the FAT-2 base than the IMF staff suggests in its discussion of the FAT-3. All one needs to provide to discourage risky betting that may reflect hidden tail risk is some sort of mechanism for applying a higher tax rate to large rates of return than to smaller or negative ones. For example, although without any implication that this is necessarily the best way of doing it, one could simply provide that the ACE or ACC deduction for the normal rate of return was nonrefundable.

[80]IMF staff, *supra* note 5, at 68.

[81]Under an income tax, loss refundability can lead to tax planning games to generate payments for the government based, for example, on fake tax losses that reflect taking advantage of the realization requirement. Under a cash-flow-based tax, however, this is not as great a problem.

[82]The FAT-3 might, however, allow carryovers of unused tax-free rate of return deductions as between tax years, thus providing the equivalent of income averaging. This would focus it on firms that had average returns above the target level, rather than on firms that had volatile annual cash flows or a limited ability to engage in self-help by shifting cash flows between adjoining years.

E. Combining the IMF's FAT Proposals

As the previous section showed, there are distinct rationales for the FAT-1, the FAT-2, and the FAT-3. However, those rationales are not logically inconsistent. Indeed, one may believe that each has some validity, and thus that any FAT being supported for adoption should have elements of each.

Suppose we conclude that the financial sector is both deriving true rents that can efficiently be taxed away and placing socially undesirable ''heads we win, tails you lose'' bets that yield high observed profitability when the hidden tail risk fails to eventuate. One might want both to tax all observed above-normal returns and to have a nonlinear tax rate that either rises with profitability (perhaps with a degree of multiyear averaging) or that treats losses (or ACE/ACC deductions that create or increase losses) unfavorably. We could call this system the FAT-2-3.

Even having done that, one might still want to address, through the FAT-1, any remaining net subsidies to the financial sector. That, in turn, might support taxing not just financial sector profits, but also any wages that were deductible under the FAT-2. Arguably, however, the FAT-1 rate should be lower than that for the FAT-2-3, given the cascading problem when it applies to business inputs, as well as the FAT-1's imperfect fit with the subsidies that it offsets.

The idea of imposing a multi-rate FAT-1-2-3 may sound more complicated than it is. All it would require, once the FAT-2-3 had been designed, is imposing a tax — at a rate below those generally applicable under the FAT-2-3 — on the amount of ordinary wages that was deductible under the FAT-2-3 component.

To illustrate, suppose that the tax rate under the FAT-2-3 was 20 percent (leaving aside the nonlinear rate features that discouraged risk taking), and that one wanted a tax rate of only 10 percent on the FAT-1 component of financial sector ordinary wages. Suppose further that a financial firm had net cash flows, for FAT-2-3 purposes, of $20 million, but also had paid $15 million of wages that were deductible in making that computation. The tax under the FAT-1-2-3 would equal $4 million on the FAT-2-3 part of the base, plus $1.5 million on the wage component, for a grand total of $5.5 million. Indeed, although this is perhaps just a semantic point, one could define the FAT-2-3 as merely a special case of the FAT-1-2-3, in which the tax rate for the ordinary wage base happens to be set at zero.

In evaluating whether the tax rate for the ordinary wage base component should be positive, one important question is what other means could be used to address the financial sector's net subsidy. One alternative approach might be to impose a higher corporate tax rate on financial sector firms or activities than on the rest of the corporate sector. However, that would build on the inefficiencies associated with the existing corporate income tax. A second approach might be to tackle the VAT and income tax exclusions more directly, within one or both of those systems. There is extensive literature on that topic.[83] Even short of identifying a fundamental fix, one might consider lesser measures, such as imputing for income tax purposes a minimum interest rate on checking and savings accounts.[84]

III. Rationales for Financial Sector Taxation

With that FTT and FAT background in place, let us now consider the objectives that increased financial sector taxation might serve. I will start with those identified by the commission and move on to others that may be relevant.

A. Raising Revenue

The first objective identified by the commission is to raise revenue. In that respect, there is no doubt that an FTT can be a powerful tool, at least if avoidance is sufficiently addressed. For example, the commission suggests that its FTT proposal might raise at least €16.4 billion if its tax rate was 0.01 percent, and at least €73.3 billion if its tax rate was 0.1 percent.[85]

An FAT can potentially raise comparable revenue, although that would require significantly higher statutory tax rates.[86] For example, the FAT-1

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[83]*See, e.g.*, David F. Bradford, ''Treatment of Financial Services Under Income and Consumption Taxes,'' in *Economic Effects of Fundamental Tax Reform* (1996); Harry Grubert and James Mackie, ''Must Financial Services Be Taxed Under a Consumption Tax?'' 53 *Nat'l Tax J.* 23 (2000); Alan Schenk, ''Taxation of Financial Services (Including Insurance) Under a U.S. Value-Added Tax,'' 63 *Tax L. Rev.* 409 (2010).

[84]To aid the political feasibility of imputing a minimum rate to low-interest checking accounts, the tax might be collected from the bank, rather than the depositor. That presumably would have the same economic incidence as requiring inclusion by the depositor, although it might change the applicable marginal tax rate.

[85]European Commission, *supra* note 3, at 9-10. The Joint Committee on Taxation reportedly estimated that the DeFazio-Harkin FTT proposal would raise more than $350 billion from 2013 through 2021 (an average of almost $40 billion per year), with a tax rate of only 0.03 percent. *See* Zeke Miller, ''Democrats Push Financial Transactions Tax, Say It Would Raise $350 Billion,'' *Business Insider*, Nov. 7, 2011.

[86]The European Commission concludes that the FTT has greater revenue potential, but that is based on comparing it to a FAT ''at an illustrative tax rate of 5 percent,'' which it states would raise between €9.3 billion and €30.3 billion, ''depending on assumptions on relocation and design.'' European Commission, *supra* note 3, at 5. That likely refers to something like FAT-1.

tax base might cover about 3 to 4 percent of GDP in the European Union, and the FAT-2 tax base about 2 percent.[87] Since GDP in the EU exceeded $12 trillion in 2010, and presumably should continue growing even with recessionary concerns, it is not unreasonable to posit overall tax bases in the neighborhood of $500 billion for FAT-1 and $250 billion for FAT-2. Thus, even with significant behavioral and tax planning responses, either instrument might be able to raise revenues approximating those available from an FTT without setting the statutory rate at anything approaching confiscatory levels.

It would be a mistake to consider the FTT's potentially high revenue yield, relative to the statutory rate applied, as evidence in its favor. As has been noted:

> Supporters [of FTTs] often tie this feature to the oft-quoted tax policy mantra favoring "broad-based, low-rate" taxes over narrow-base, high-rate taxes. But the logic behind this mantra does not apply to any and all broad-based taxes, regardless of their underlying efficiency properties. Thus, for example, economically well-informed proponents of retail sales taxes generally agree that "broadening" the base by including business-to business sales, rather than just those to consumers, and thus creating a gross receipts (or turnover) tax, would reduce, rather than increase, economic efficiency, by generating a cascading tax on economic production by multiple non-integrated firms.[88]

Likewise, "broadening" the income tax base by making it a tax on gross, rather than net, income would likely not be an improvement, even though it might permit raising the same revenue with a nominally much lower rate.

More generally, revenue-raising capacity is not where discussion of the FTT's and FAT's relative merits should focus. After all, if one simply wanted to raise as much revenue as possible, there are myriad ways of doing so. Consider, for example, a per-person or "head" tax on each resident individual, or a tax based on the number of letters in each taxpayer's name. Instruments like those could surely raise vast amounts of revenue, but they might also rightly generate little support. The aim is not just to raise revenue, but to do so in a manner that is reasonably appealing from the standpoints of efficiency and distribution. That, however, requires examining objectives other than just revenue raising.[89]

The commission may have in mind a point about revenue-raising potential that takes into account political considerations. Suppose that greater tax revenues are needed, but that grave political obstacles impede obtaining them by any rational means (or perhaps, as has recently been the case in U.S. politics, by any means whatever). Then the fact that an FTT could raise billions in revenue at an extremely low statutory rate, while also garnering plaudits as a supposed "Robin Hood tax,"[90] might count seriously in its favor. Even if one believed that various alternatives (like the FAT) are better, those might reasonably be viewed as politically irrelevant if their chances of enactment are too low. The commission does not state any such argument, however.

B. Ensuring a Fair and Substantial Contribution

This goal, mentioned by both the IMF staff and the commission, arguably requires more explanation than either has given it. I therefore offer some general observations before turning to the FTT and FAT in particular.

1. What is the financial sector? Just as only people, not intangible legal entities like corporations, can actually bear the corporate tax, so the financial sector cannot itself contribute substantially, much less fairly, to the public fisc. Calls for fiscal contributions from the sector surely pertain to some set of individuals, but which ones?

The answer may initially seem clear. Calls for the financial sector to pay are surely directed, at least in the main, neither at its customers (whom the commission expressly wants to hold harmless) nor even at diversified shareholders who may happen to hold a smattering of the firms' shares in their broader stock portfolios. The primary target presumably is the people who control financial firms or work for them as high-level, highly compensated

[87]I base that estimate on eyeballing the range of GDP percentages for various EU countries. In the United Kingdom, for example, the FAT-1 would cover an estimated 6.1 percent of GDP, and the FAT-2, 2.7 percent. For Germany, with its less prominent financial sector, those numbers would be 3.6 percent and 1.5 percent, respectively. *See* IMF staff, *supra* note 5, at 70.

[88]*See* Shackelford et al., *supra* note 78, at 797.

[89]In support of viewing the FTT's estimated revenue effects positively, the Committee on Economic and Monetary Affairs of the European Parliament cites a recent report — Stephany Griffith-Jones and Avinash Persaud, "Financial Transactions Taxes" (2012) — that says the commission's proposed FTT could actually have positive effects on GDP growth (on the order of 0.25 percent annually), rather than the negative effects conceded in the commission's study. That estimate is based on the view that the FTT will have such favorable effects as reducing systemic risk, providing funding for needed government outlays, and permitting other distortive taxes to be reduced. *See supra* note 3, at 15-16.

[90]*See* http://robinhoodtax.org/, a pro-FTT website that labels the FTT the "Robin Hood Tax."

employees. Members of that group have been an inescapable cultural, political, and economic presence in Europe and the United States for decades now, alternately (or perhaps simultaneously) attracting public fascination, emulation, envy, and anger. Consider the film *Wall Street*'s notorious Gordon Gekko, as well as the ''Masters of the Universe'' in Tom Wolfe's novel *Bonfire of the Vanities* — both dating from 1987 — or, from 2009, the white-hot controversy on both sides of the Atlantic Ocean regarding bonus payments to executives at recently bailed-out financial firms.

There is potential ambiguity, however, regarding whether our concern about fair and substantial tax contributions from members of that group, taking into account the bailout side of the equation, is meant to apply at the individual or the group level. New financial sector ''Masters of the Universe'' are continually cycling in to replace the old, as the business schools discharge more graduates and the sated minions of prior economic cycles retire to their newly purchased country estates. Thus, if one is concerned about beneficiaries of the 2008 bailouts, a tax that takes effect in 2014 might come too late to extract a fair contribution from them. Backward-looking taxes typically have at best a short window in which they can hit their targets, unless they are explicitly retroactive. Only if we are concerned about the possible next wave of bailouts, and about making particular actors bear the ex ante expected cost rather than the ex post realized cost, does that problem become less critical.

2. What are the grounds for favoring a fair and substantial contribution from the financial sector actors? Unobjectionable though it may be to require that the people whom we identify with the financial sector make a fair and substantial contribution, it still is important to specify why. At a minimum, that inquiry may be needed to assess whether a tax instrument can satisfy the underlying objective.

The reference to a fair contribution unmistakably sounds in equity or distributional concerns, rather than those of efficiency. Obviously, the fact that the people who are meant to be evoked by the financial sector are generally at the top of the income scale contributes to the appeal of requiring a fair contribution from them. Handing them bailout funds that are then recouped from average taxpayers may not be an attractive distributional outcome. However, the question is not just one of progressivity versus regressivity, or else we would focus on ensuring that rich people in general bear enough of the cost of bailouts (or of government spending generally). It appears clear that something like the benefit theory of taxation, which holds that people should pay for the benefits that they derive from the government's activities — or perhaps the ''polluter pays'' approach to assigning liability for harm — is playing a primary role here.

I myself am not persuaded that benefit tax principles, as opposed to an ''ability to pay'' approach (or, better still from my standpoint, utilitarianism and related welfare economics), should govern distributional analysis of tax policy. I also believe that the polluter-pays approach to assigning liability for harm is best rationalized in terms of efficiency, rather than on distributional grounds. The goal is to give potential polluters the right incentives regarding potentially harm-causing activity. But even for people who differ from me in that they subscribe to principles of distributive desert that are not entirely welfare-based, implementing those principles through a tax on the financial sector is inherently challenging. While I have already noted the difficulty of looking backward and imposing burdens on malefactors (or even mere freeloaders) who may already have left the scene, there is also a potential difficulty associated with looking forward.

The problem is transition. Suppose the financial sector is receiving huge subsidies because of the undertaxation of financial services to consumers under the VAT and the income tax, along with the prospect of unfunded bailouts. That certainly would be expected to increase the size of the financial sector. However, it would not necessarily increase the returns earned by specific financial-sector owners or high-ranking employees. If capital and highly compensated labor are free to flow into the financial sector as long as the returns there are higher than elsewhere, presumably they will do so until equilibrium is reached through elimination of the disparity in available returns.

To be sure, such an analysis may need to be modified if we posit that people in the financial sector are earning rents. But insofar as the analysis holds, increasing the tax burden on the sector might only reduce the returns being earned by people in the sector when it was first announced. The smaller financial sector that remained once the reduction of sectoral subsidies caused others to exit would not necessarily feature smaller returns for the people who were still there.

Such a shrinking of the financial sector would clearly be desirable on efficiency grounds, if subsidies have made it too large. And that might be all the more true if one views the financial sector's extraordinary growth over the last two decades as reflecting some broader malfunctioning or even pathology of our economic system that is not entirely explicable in terms of the subsidies. But one should clearly distinguish that line of argument from demanding fair contributions on equity grounds.

How should one think, from a purely distributional standpoint, about making the financial sector smaller or (if this was feasible through the FTT or FAT) less hyperprofitable at the top? A conventional economic analysis might suggest that the best approach is simply to focus on overall wealth distribution as the factor to balance (when necessary) against considerations of efficiency, rather than focusing for distributional purposes on the size of any particular sector or the structure of economic returns within it. But if one is skeptical that the decades-long rise of the financial sector entirely reflects the standard story of markets driven by the preferences of rational actors directing resources to their highest and best uses, then one may come to view the efficiency failures that arguably have helped to produce a bloated and overrich financial sector as having broader negative distributional externalities that should be addressed if possible.

I derive several conclusions from this discussion. Despite the equity-based rhetoric of the phrase ''fair and substantial contribution,'' the underlying concerns are mainly about efficiency — in particular, giving market actors appropriate incentives (such as when they make risky bets) and addressing resource misallocations through subsidies to the financial sector. However, there also are plausible distributional reasons for favoring a smaller financial sector, and one in which the returns are not so heavily concentrated at the top. Those distributional concerns suggest that it should not particularly matter whether a new tax on the financial sector targets the right set of individuals (defined in terms of who received ''unfair'' benefits) as one age cohort succeeds the next in the sector's front lines.

3. Assessing the FTT and the FAT with respect to fair contribution. Enactment of either the FTT or the FAT could result in a smaller financial sector. In other respects, however, the taxes may differ significantly in their likely distributional effects. Starting with the FTT, if selling financial assets and issuing derivative financial instruments is newly tax-discouraged, the size of the financial sector may decline insofar as it is engaged in providing related services. However, as the IMF staff report points out, ''a large part of the burden may well be passed on to the users of financial services (both businesses and individuals) in the form of reduced returns to saving, higher costs of borrowing, and/or increases in final commodity prices. . . . It is not obvious that the incidence would fall mainly on either the better-off or financial sector rents.''[91] The report further states that shifting the incidence of the FTT from people in the financial sector to consumers is especially likely if the tax applies broadly.[92] The commission, despite arguing that households and small to medium-size business enterprises will ''hardly be affected'' by the FTT,[93] elsewhere concedes that a ''large part of the burden would fall on direct and indirect owners of traded financial instruments.''[94]

The FAT has considerably more promise from the distributional standpoint of targeting big players in the financial sector.[95] In particular, to the extent that it focuses on rents (which is at least the intended effect of FAT-2), those deriving the rents appear likely to bear the tax burden. If they are already earning above-normal returns, then presumably they are extracting what the market will bear and cannot react to the tax by demanding even higher pretax returns. However, the FAT's application to compensation that does not reflect the earning of rents, including high-end compensation identified by FAT-2 that merely reflects ''returns due to high productivity, . . . would likely be passed on to purchasers of financial services.''[96]

C. Reducing Undesirable Market Behavior

The commission argues that ''the FTT might be an appropriate tool to reduce excessive risk-taking to the extent that short-term trading and highly leveraged derivative trading creates systemic risks.''[97] By contrast, it views the FAT as ''only . . . an indirect measure to tackle [excessive] risk-taking.''[98]

Regarding the FAT, the question of interest is not direction versus indirection, but the magnitude of the expected effect from having nonlinear rates. As long as a risky investment is treated asymmetrically, such that it bears a higher expected tax liability than it would if it were certain to achieve its expected return, it is being tax discouraged. However, the magnitude, and indeed the basic significance, of the response is admittedly open to question. Further, insofar as the FAT rates are

[91]IMF staff, *supra* note 5, at 20-21.

[92]*See id.* at 20.

[93]European Commission, *supra* note 35, at article 35.

[94]European Commission, *supra* note 3, at 11.

[95]It may be only fair to point out that a problem noted by the IMF staff regarding the FTT — that a tax instrument's ''cumulative, cascading effects'' when it applies to interbusiness transactions ''can be significant and non-transparent'' — potentially applies to the FAT as well, given that it might apply in cascading fashion to interbusiness transactions between financial and nonfinancial firms. Again, that problem would not be entirely eliminated by charging the FAT ''at lower than the generally prevailing VAT rate in order to limit the damage'' and thus creating overall balance between cases of aggregate undertaxation from a VAT-equivalence standpoint (in the absence of cascading) and those of overtaxation. *See supra* note 5.

[96]*Id.* at 23.

[97]European Commission, *supra* note 3, at 5.

[98]*Id.*

symmetric, they could conceivably induce increased pretax risk taking by financial firms.

Regarding the FTT, it is far from clear whether systemic risk would decline. The commission emphasizes the tax discouragement of trading strategies that may increase volatility. To similar effect, others note that an FTT ''may reduce activity by 'noise traders,' who trade on spurious information such as past price movements and are thought to destabilize markets. . . . However, it may also suppress activity by informed traders and arbitrageurs, whose trading tends to push prices towards their fundamental values.''[99]

More generally, the problem is that with thin, incomplete, or otherwise imperfect markets, both positive and negative externalities from trading activity may be rife. Thus, theoretical models suggest that ''volatility may either rise or fall upon introduction of an STT, depending on the market microstructure,'' and that the tax is unable ''to discriminate between discouraging stabilizing and destabilizing trading activity.''[100] If one knew that the STT would disproportionately drive from the marketplace those engaged in ''bad,'' rather than ''good,'' trading, there might be grounds for optimism. But if we could tell apart the two types of trading, then a better approach still might be just to tax (or regulate) the bad part of the marketplace.

Absent the ability to discriminate, it is hard to be sure whether the tax has a greater discouraging effect on the good trading or the bad. Presumably for those reasons, empirical studies generally fail to support the view that an STT can be expected to reduce either short-term price volatility or the occurrence of price bubbles and crashes.[101] And just anecdotally, it is clear that bubbles and crashes can plague asset markets in which trading is costly and thus relatively sporadic. A case in point is the U.S. real estate market in the first decade of the 21st century. In sum, there is little clear support for the commission's hope that the FTT would help stabilize markets.

D. Achieving Coordination

A final reason advanced in support of the commission's FTT proposal is that it might help in achieving coordination between different member states' internal taxes. Even if the enactment of an FTT is otherwise a bad idea, that consideration may have some merit insofar as, in the alternative, member states might enact their own FTT variants. Uniformity would at least limit tax competition and national variation between applicable FTTs within the European Union. FTTs and similar instruments are not widespread within the EU, although the French government recently indicated that it plans to enact one unilaterally, and Germany has said it may follow suit. The United Kingdom, which has Europe's largest financial sector, appears unlikely to do so.

Even if particular countries at least briefly bite the bullet of acting unilaterally, the adoption and retention of significant national-level FTTs may tend to be discouraged by concern about tax competition. Again, the recent Swedish experience suggests that initial exuberance may rapidly fade if restructuring to avoid the tax is rife. On balance, then, it is not clear how strongly this factor weighs in favor of the commission's proposal, at least if one is otherwise agnostic about the desirability of having any FTT at all.

E. Other Relevant Considerations

Several other considerations may be relevant in evaluating whether to enact an FTT, a FAT, or neither. They include:

- *VAT and income tax undertaxation of the financial sector* — Assuming that this problem cannot be addressed more directly, such as through the VAT and income tax themselves, the FAT has an important advantage over the FTT in responding to it. Whereas the FTT only reaches specified transactions like securities trading and (at a much lower tax rate) derivatives transactions under the commission's proposal, the FAT applies to financial sector activities generally.
- *Income tax bias in favor of debt relative to equity* — Existing corporate income taxes generally favor debt over equity, in particular by providing that corporate taxpayers can deduct interest expense but not dividends. The FTT might exacerbate that bias. Although securities that are traded in secondary markets would generally be subject to the FTT whether classified for income tax purposes as debt or as equity, the latter instruments tend to be traded more.
- *Tax competition from outside the taxing jurisdiction* — As noted above, even an EU-wide FTT would discourage the use of European financial sector companies by non-EU persons to conduct taxable securities trades and derivatives transactions. By contrast, the FAT-2, at least to the extent that the tax base succeeded in identifying rents, should not have that effect, given that higher-ups in the resident financial sector firm presumably would bear it. On the other hand, the FAT-2 could discourage the organizers of potentially taxable firms from choosing European residence.

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[99]Thornton Matheson, ''Taxing Financial Transactions: Issues and Evidence,'' IMF working paper (2011), at 20.

[100]*Id.*

[101]*Id.* at 20-21.

- *Defining taxpayers* — While the FTT may create serious problems in identifying taxable transactions, it is likely to be less problematic than the FAT in identifying taxpayers. As noted earlier, the commission's proposal identifies potential taxpayers very broadly, reflecting that the stakes are lowered by the fact that only the taxable transactions engaged in by those entities would lead to FTT liability. Under the FAT, a financial sector firm (or branch within a firm) presumably is taxable on all its relevant activities. Accordingly, the classification stakes may be higher under the FAT than the FTT, and the cost of error more significant. In that regard, particular difficulty may arise because ''financial [and other] institutions with different designations often perform overlapping functions and sell overlapping products.''[102] Moreover, one needs to address the existence of ''predominantly non-financial firms with financial units.''[103] On the other hand, countries that exempt financial firms from VATs have apparently not found that prohibitively difficult.
- *Progressivity in the presence of political constraints* — I argued earlier that while the FTT should not be preferred to the FAT on the grounds that it can offer a higher revenue yield relative to the statutory rate being applied, political constraints on rational revenue raising might make that an advantage after all. The same point could apply to the goals of increasing the progressivity of the overall tax system. The FTT is far from being an optimal mechanism for increasing progressivity, if that is the only reason for it, given the unmitigated distortions that it causes if one is not persuaded by the efficiency arguments for it. Moreover, it would likely be less progressive in incidence than the FAT-2, since it does not target high-end financial sector rents. However, if all other progressive tax changes are assumed to be politically unavailable, the FTT might be considered better than nothing, at least if one believes that it is borne by investors, who tend to be relatively affluent.

IV. An Alternative FTT Rationale

Efficiency analysis in tax policy often assumes that taxpayers will have suitable incentives when guided by pretax profitability unless there are clear and tangible externalities, like those resulting from financial firms' ''heads I win, tails you lose'' betting opportunities, or from industrial pollution. At least one potentially important type of externality is often ignored. Suppose I find two economic opportunities, but can pursue only one of them. The first would offer an economic reward worth $10 million, but if I don't secure it, someone else will. The second would offer an economic reward worth $9 million, but if I don't secure it, it will go unclaimed. If the costs I would incur to get either (as well as the probability of success) are the same, I will presumably seek the first reward. But that would cause aggregate social returns to be $9 million lower than if I had chosen to pursue the second reward. That the first reward but not the second would, in effect, come out of someone else's pocket is an externality that I have no reason to care about.

The reason for commonly ignoring considerations of that kind is that outside the tidy boundaries of a hypothetical, the considerations may be prohibitively difficult to identify and measure. Externalities are rife in the world around us, but we cannot take account of them all. Moreover, the general economic success over many decades of free market economies relative to those that are more centrally managed and thus limit competition between businesses that are seeking to fill the same niche, may be viewed as supporting the intuition that ignoring externalities of that kind leads to reasonably good results overall.

Nonetheless, there are times when it may be desirable to take account of the externality that results when people compete for the same prize. One recent example is the literature arguing that high-return labor markets increasingly are winner-take-all ''tournaments'' in which many compete for rewards that only a few can win, potentially with important tax policy implications, such as strengthening the case for progressive redistribution or highly graduated marginal income tax rates.[104]

Likewise, in the literature on the economics of information, an influential paper by Jack Hirshleifer notes that the socially optimal level of intellectual property protection is strongly affected, and potentially greatly reduced, by the occurrence of patent

[102] *See* Shackelford et al., *supra* note 78, at 794.
[103] *Id.*

[104] *See, e.g.*, Robert H. Frank and Philip J. Cook, *The Winner-Take-All Society: How More and More Americans Compete for Ever Fewer and Bigger Prizes, Encouraging Economic Waste, Income Inequality, and an Impoverished Cultural Life* (1995); Martin J. McMahon and Alice G. Abreu, ''Winner-Take-All Markets: Easing the Case for Progressive Taxation,'' 4 *Fla. Tax Rev.* 1 (1998); and Shaviro, ''1986-Style Tax Reform: A Good Idea Whose Time Has Passed,'' *Tax Notes*, May 23, 2011, p. 817, *Doc 2011-8373*, or *2011 TNT 100-9*.

races.[105] In a patent race, multiple inventors are competing to be the first person to perfect and publish a type of invention that many people have realized might be feasible. If I get there first, just one day ahead of the runner-up, I will receive the entire patent reward, even though the social benefit from my efforts is limited to that from people getting the information a day sooner.[106]

Now consider financial market profits from securities trading. Each trade, insofar as it reflects differing predictions regarding future value, ends up having a winner and a loser. In the Keynes beauty contest scenario, the game has no aggregate social value (other than its being enjoyed as a consumption activity) and merely leads to zero-sum transfers from the losers to the winners. But even if public securities trading also helps to ensure the proper allocation of resources through the ongoing incorporation of new information into securities prices, there is a Hirshleifer element to the profit from being the first to discover and trade on new information that affects value. That is, the private gain exceeds the social gain under the same analysis as that applying to patent races. It is clear, moreover, that huge resources are devoted to seeking trading profits.[107]

Suppose we therefore conclude that it would be socially desirable to tax-discourage and thereby reduce the effort that people invest in the pursuit of trading gains. If the thing we want to discourage cannot be observed directly, we might instead choose to tax proxies that are correlated with it in practice. If trading securities more rather than less (in terms of the value traded) is indeed an empirically robust proxy for the socially excessive pursuit of trading gains, then the FTT could yield social benefit at that margin even if the act of trading itself has no negative externalities in the aggregate.

In my view, that line of argument may establish a plausible motivation for enacting an FTT. So may Keynes's argument, discussed earlier, if one believes that more frequent trading (and thus shorter average holding periods) worsens resource allocation or promotes damaging short-termism. As noted above, however, those arguments are hard to assess definitively. And even if one does accept them, the next step is weighing the expected efficiency gain against such efficiency costs of the FTT as its discouraging trades that the parties would value, imposing cascading taxes within the business sector, and inducing wasteful tax avoidance behavior.[108]

One also could perhaps devise alternative means of pursuing the Hirshleifer and Keynes objectives. One possibility might be to have the income tax rate on gains from selling publicly traded financial assets start relatively high and decline gradually with the length of the holding period. U.S. federal income tax law does that in one respect: by imposing a long-term capital gains rate (currently 20 percent) on capital assets that have been held for at least a year, but imposing a 35 percent top rate on assets held for less than a year. The capital gains tax then entirely disappears if one holds the stock (or any other appreciated asset) until death. That approach, however, uses only two specific time windows, each involving a sharp discontinuity. One could imagine replacing it with an approach — just for publicly traded stock — under which the applicable tax rate declines more smoothly and gradually.[109]

No matter how the FTT analysis comes out, however, it has little evident relationship to the risk of future financial crises, to any of the other main grounds advanced by the commission in support of an FTT, and to the question whether a FAT has been enacted. Thus, the best case for enacting an FTT lies outside the "FAT or FTT" framework that has dominated much recent discussion, particularly in Europe.

V. Conclusion

There are several good grounds for raising taxes on firms in the financial sector:

- Various financial services to consumers are treated preferentially by income taxes and VATs. The income tax preference may be greater overall, although it is less commonly emphasized.
- The financial sector as a whole is implicitly subsidized by the prospect of bailout if financial firms' failure endangers national or global macroeconomic performance. Bank regulation, along with bank taxes other than the FTT and

[105]Jack Hirshleifer, "The Private and Social Value of Information and the Reward to Inventive Activity," 61 *Am. Econ. Rev.* 561 (1971).

[106]*See generally* Joseph E. Stiglitz, "Using Tax Policy to Curb Speculative Short-Term Trading," 3 *J. Fin. Serv. Res.* 101 (1989).

[107]*See, e.g.*, Lawrence H. Summers and Victoria P. Summers, "When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax," 3 *J. Fin. Serv. Res.* 261 (1989); Stout, "Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation," 81 *Va. L. Rev.* 611 (1995).

[108]For a view that is similarly uncertain regarding the bottom line, see Lee A. Sheppard and Martin A. Sullivan, "Should the U.S. and U.K. Enact a Securities Transfer Tax?" *Tax Notes*, Sept. 14, 2009, p. 1055, *Doc 2009-20010*, or *2009 TNT 175-3*. For a more favorable view, see Dean Baker, *The Benefits of a Financial Transactions Tax* (2008).

[109]Among the difficulties that approach would involve is how to net capital losses against different-period capital gains.

FAT, may fail to entirely solve this problem, even if it ameliorates it.

- The key actors in financial firms may often have opportunities to derive rents that can be efficiently and progressively taxed.
- Those same actors may often have the opportunity (despite financial sector regulation) to benefit from choosing investments that offer extra-normal returns most of the time while occasionally experiencing dramatic losses that will end up being someone else's problem.

Insofar as those concerns could be addressed by enacting either an FTT or a FAT, I have argued that the case for a FAT is much stronger. The variant I propose, which for want of a better name I call the FAT-1-2-3, would tax financial firms' ordinary wage base at a low rate and their profits at a higher rate that is in some sense nonlinear so as to discourage risk taking.

A final point of interest concerns the almost entirely separate case for an FTT that is rationalized as a mechanism for discouraging the socially excessive pursuit of trading profits. Here the case for imposing a tax on securities values traded would rest on the view that that is a decent proxy for the actual underlying concern, rather than on the claim that the trading itself imposes net negative externalities. However, whether an FTT that was thus rationalized would be desirable on balance depends on how one assesses the trade-off between its potential benefit and its undoubted efficiency costs, as well as by the availability and merits of alternative tax instruments.

Finally, the desirability of enacting an FTT may be affected by broader political economy constraints on revenue raising and on the pursuit of greater tax progressivity by alternative means. Even if the FTT is clearly inferior to other tax changes that could similarly raise revenue and reduce wealth inequality, it might be not only better than doing nothing, but also the best tax instrument realistically available at the time.