Is a European Tobin tax likely to be efficient?

di Donato Masciandaro e Francesco Passarelli

www.voxeu.com

11 gennaio 2012

Italy's prime minister, Mario Monti, is the latest in a growing line of senior public figures to support the idea of a financial transaction tax - also known as a Tobin tax or Robin Hood tax. Rather than give a case for or against, this column looks at what the realistic options are and asks whether they will be better for Europe, or worse.

Last month, Italian Prime Minister Mario Monti announced that Italy is willing to reconsider its position on the so-called European Tobin tax, which had been opposed by the previous government. The renewed Italian support reinforces the European Commission's September 2011 proposal to tax financial transactions. The proposal has given rise to a popular debate, in which the new tax has been viewed not only as a way to let financial institutions pay for their responsibility for the economic crisis (Persaud 2011), but also as a fundamental component of a broader reshaping of policy intervention in the financial markets (Beck and Huizinga 2011).

Taxation can be a powerful tool for curbing systemic risk, a peculiar case of externality resulting from contagion in financial markets. The externality arises because contagion effects are not completely internalised by the contracting parties. The possible failure of a specific portfolio can produce a generalised fear of counter-party credit risk, with potential domino effects that spread through the markets.

So far, the debate has considered normative aspects; for example, which is the best policy, and what its optimal level should be. The "positive" aspects have been somehow disregarded. We do not have even tentative answers, therefore, to questions like: "Which instrument are policymakers more likely to select, and at what level?"

Here, we claim that when policies to reduce financial systemic risk are decided by voting, political distortions may occur. Specifically, regulation yields a progressive effect since it has a much stronger impact on portfolios with a large share of toxic instruments. In this situation, a majority of low-risk portfolio owners has an incentive to choose harsh regulation in order to concentrate sacrifices on high-risk portfolio owners. By contrast, a tax on financial transactions is likely to yield a regressive effect - small-risk producers pay proportionally more than large-risk producers. In this case, a majority of small portfolio owners will tend to choose a tax level that is too low (Masciandaro and Passarelli 2011, Alesina and Passarelli 2010).

This argument is based on the idea that intervention in financial markets is a general interest policy. If this is the case, the idea that policymaking reflects the opinion of the majority is supported. If not, policymaking would instead reflect the lobbying of banks and other financial institutions. We think that the financial crisis has increased everybody's concerns about the way financial markets are regulated or taxed. Therefore, interventions for curbing systemic risk have recently become a general, rather than a specific, policy issue.

Political distortions hinge on the distribution of sacrifices for the reduction of systemic risk. With regulation, the effect is highly progressive – only those who produce large risk have to make compliance sacrifices. Regulation is less subject to a measurement problem. Rules can be more detailed and easier to implement than taxation. Regulation can be designed to produce progressive effects in economic agents' risk taking. Moreover, soft information is easier to use in regulation

than in taxation (Claessens et al. 2010). Under these conditions, majorities will tend to choose rules that are too restrictive. However, if systemic risk is produced by “everybody”, with of course each producing different amounts, concentrating risk reduction on the top risk producers is not socially optimal. Thus, the consequence is too much and too restrictive regulation.

Taxes are superior to regulation in many respects. Flat taxation schemes may be used to produce more proportional effects (Goodhart 2010). One of the major advantages of taxation is that no information about the private cost of reducing risk is required in order to reach the socially optimal level of risk. Loosely speaking, with a tax everybody can choose his best combination between the sacrifice of reducing risk and the sacrifice of paying the tax. Of course, we need the tax to actually be levied on a non-distorted measure of risk production. In fact, a financial transactions tax is charged on a quite distorted and extremely regressive measure of risk production. Realistically, the measurement problem is rather severe with this kind of taxation. The regressivity can cause large political distortions. As already pointed out, we may expect a majority of low-risk producers to choose a tax that is too low. This may explain why, in reality, taxes on financial instruments are usually rare and low.

An efficient European Tobin tax is unlikely to emerge if it is charged just on financial transactions. When deciding on the tax, a huge political distortion can occur, and possibly is occurring. We think that, as so far as a financial tax is aimed at curbing systemic risk rather than transactions, a more precise measure of toxicity should be adopted as the taxation basis (Acharya et al. 2009, Adrian and Brunnermeier 2009). This would also help to reduce the distortion caused by the adoption through a political process. With a more precise measure of toxicity, the political decision on the level of the tax would be more efficient.

References

Acharya V, L Pedersen, T Philippon and M Richardson (2009), “Regulating Systemic Risk”, in V Acharya and M Richardson (eds.), Restoring Financial Stability: How to Repair a Failed System, Wiley.

Adrian T and M Brunnermeier (2009), “CoVar”, Staff Report, Federal Reserve Bank of New York, No. 348.

Alesina, A and F Passarelli (2010), “Regulation versus Taxation”, NBER Working Papers No. 16413.

Beck T and H Huizinga (2011), "Taxing Banks – here we go again", Vox, October 25.

Claessens S, M Keen, and C Pazarbasioglu (2010), The Financial Sector Taxation, IMF, September.

Goodhart CAH (2010), “The New Emerging Architectures of Financial Regulation”, mimeo.

Masciandaro, Donato and Francesco Passarelli (2011), “Financial Systemic Risk: Taxation or Regulation?”, Working Paper Series, Paolo Baffi Centre, Bocconi University, 91.

Persaud A (2011), “EU’s Financial Transaction Tax is feasible and, and if set right, desirable”, VoxEU.org, 30 September.