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The folly of the Robin Hood Tax: If you think that a financial transaction tax is a good idea, think again

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Earlier this year, 11 Eurozone countries – including Germany, France and Italy – moved ahead with the creation of a Financial Transaction Tax – also known as the Tobin Tax. At first sight, a tax of 0.1 per cent on equity and fixed income transactions and 0.01 per cent on derivatives seems inconsequential. Yet its proponents seem to believe that the tax can help stabilise public finances by offering a new source of revenue, and that it will also help curb excesses in the financial industry, which were behind the financial crisis of 2008 – and possibly behind the recent sovereign debt crisis raging in the Eurozone.

This view was summarised by Algirdas Šemeta, the European Commissioner for taxes, in The Guardian:
"First, [governments] are responding to the persistent demands of their citizens, who have long called for a harmonized FTT in Europe. The levy will ensure that the under-taxed financial sector finally makes a fair contribution to the public purse. [...] Second, the tax offers substantial new revenues. Around €30-35bn (£26-30bn) per year will be generated from this small tax of just 0.1 per cent on bonds and shares and 0.01 per cent on derivatives. [...] Finally, it should help to deter the irresponsible financial trading that contributed to the crisis we are in today."

All three of these claims are unfounded. The FTT will not be a boon for public budgets, nor will it prevent new financial crises. Instead, the new tax will likely have unintended consequences that will damage economic growth on the European continent and beyond. The biggest losers in the process will be the governments of countries that are attempting to improve their tax and regulatory systems and make them more accommodative of foreign investment. Given the extraterritorial nature of the tax, high tax governments will be able to levy an FTT on transactions done outside of their jurisdictions – an issue that should be worrying both to lawyers and economists.

But first things first. The idea that capital is under-taxed in current tax regimes is mistaken. If anything, tax systems that rely heavily on the taxation of income tend to tax savings more heavily than consumption. An additional levy on financial transaction will exacerbate that effect, discouraging individuals and firms from saving and investing. And because financial capital is among the most mobile factors of production, this effect can be expected to be strong – leading both to less investment and therefore to less growth in Europe.

As an illustration, recall that one of the key reasons for dismal productivity figures in the UK, according to a recent report1 by the Institute for Fiscal Studies, is the sharp fall in business investment, which is 16 per cent its pre-recession levels: "If workers have less, and less good, capital to work with, they will produce less." To discourage investment by taxing capital is

simply bad policy.

The high elasticity of investment means that the tax is unlikely to yield much revenue. Because an FTT taxes each transaction with any given security, its effect is cumulative. That means that the seemingly low tax rates are misleading, but also that the application of the tax will change the nature and frequency of financial transactions, leading to lower tax revenues than anticipated by its advocates.

Incidentally, the effect of the tax on the frequency of trading is seen as a virtue by the proponents of the tax, who argue that an FTT will reduce speculative and irresponsible trading, which was allegedly behind the financial crisis of 2008 and behind the sovereign crisis in Europe.

That belief is unwarranted. Clearly, the crisis of 2008 was not caused by financial trading as such, but rather by the implicit bailout guarantees given to large financial institutions, as well as by the numerous factors that led people to expect a continual rise in housing prices. Similarly, the loss of confidence in the ability of governments on the Eurozone's periphery to repay their debt obligations had little to do with trading on financial markets but rather much to do with the growing understanding of the unsound economic fundamentals of Greece, Cyprus or Portugal.

Perhaps, one could argue that the ability to trade instantly, at practically zero cost, might have helped to spread the panic. In that case, an FTT could moderate the economic effects of sudden shifts in confidence by limiting the volatility of asset prices. However, there is scarce evidence supporting that claim, as a recent report2 by Anna Pomeranets from the Bank of Canada concludes. If anything, there have been instances when an FTT led to an increase in market volatility – most significantly on the New York Stock Exchange and the American Stock Exchange, between 1932 and 1981 when the increases in the FTT were associated with rising volatility, increased bid-ask spreads, and lower trading volumes.

"[A]n FTT may reduce the flow of profitable investment and even employment," argues Pomeranets. And some of these effects are driven by the fact that an FTT chases away capital to other jurisdictions. In Sweden, for example, after an FTT was introduced in 1984, the trading in long-term bonds declined by 85 per cent and practically half of all the trading in Swedish stocks moved to non-Swedish markets. The current FTT directive tries to remedy this problem by being set up as an extraterritorial tax.

The transfer of any security is taxed even if it takes places outside of the relevant jurisdiction, as long as the security is considered as issued in the country that applies the FTT (the issuance principle) or if the investor is residing in the country that applies the FTT (the residence principle). That is a revolutionary change compared to existing FTTs, including UK's stamp duty, which is somewhat broader in its application than most existing taxes on financial transactions.

Extraterritoriality is an extremely contentious area, both legally and from the perspective of the political economy of taxation. The United Kingdom has already launched a legal challenge at the European Court of Justice, on the grounds that an extraterritorial tax will harm countries that are not taking part in implementing it. Even the Italian government, which initially committed to adopting an FTT, is now having second thoughts – particularly because the FTT would affect secondary trading in government bonds.

While it is far from clear what the legal implications of having an extraterritorial tax on financial

transactions are, it is quite obvious that this runs against the interests of ordinary Europeans. In its present form, the tax is an attack on tax competition, limiting the ability of governments that are not taking part in the FTT to improve their tax and institutional environments to attract capital flows. While that may make sense to the proponents of a European FTT – after all, nobody wants to chase investors out of their own country – it is likely to have nefarious effects on fiscal discipline and quality of tax systems around the world.

Tax competition – understood as the ability of government to set tax rates to attract mobile bases of revenue – has been a powerful force fostering economic efficiency and restraining governments from having recourse to more damaging fiscal instruments. In Central and Eastern Europe, for example, it was competition for mobile capital that led to profound, welfare-enhancing reforms of income taxation, including the introduction of flat taxes, some of which have sadly been reversed in recent years.

As it currently stands, an FTT is being adopted only by a subset of Eurozone countries – and even among them the commitment to the tax is questionable. The economic harm that the tax can inflict on the global economy will therefore be limited to extent to which investors and issuers of securities will be able to permanently move to friendlier jurisdictions and do their business, including the issuance of securities, from there.

The real losers in that process, unfortunately, will be the citizens of the 11 European countries who have signed up for this fool's errand – including relatively poor places such as Slovakia, Slovenia and Estonia.