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Time for a Financial Transaction Tax

Roberto Tamborini | Nov 17, 2010 6:53PM

James Tobin proposed to introduce a tax on international currency transactions in 1972[1]. Since then proposals for taxing financial transactions in general have been recurrent under the catch-all name of *Tobin Tax*. As a matter fact, 23 countries around the world have adopted a financial transaction tax (FTT), mostly as a means to cover the operating costs of domestic stock markets. Typically, tax rates are very thin (from 1 to 5 per 10,000) but revenues are substantial, ranging from 0.4% of GDP in the UK in 2009 up to 2.4% in Hong Kong in 2008. Empirical analyses do not show dramatic distortionary effects (see e.g. Thornton Matheson). Nonetheless, the Tobin Tax can hardly be recorded as a hit both academically and politically. Vocal supporters of the Tobin Tax have always presented it as a weapon "to fight financial speculation" and as a means to collect resources for ethical uses at one and the same time. These arguments have never overcome the compound obstructions erected by sceptical economists and worried financial lobbyists. This time it seems that the mood is changing.

Some top political leaders (e.g. Merkel and Sarkozy), and heads of international institutions (Barroso, Strauss-Kahn), have openly endorsed the idea of a worldwide FTT. Obama would probably not be against, if a large front at the G20 level were in favour. In Italy, for example, the parliament already has it in the agenda, and 130 economists of various persuasions (among which the present writer) have signed a supportive appeal. This unusually favourable conjuncture is easily explained. Economists arguing that financial markets are always and everywhere efficient, so that there are no reasons to interfere, are in retreat. Financial lobbyists are still active, but cannot be very vocal. Political leaders are quite sensitive to the popular claim that they should do something against speculation besides raising taxes, or cutting social expenditure, to bail out the big sharks. However, the supportive international mood and circumstances are not enough.

The Tobin Tax is still lacking a winning package of right motivations and communication drivers. In particular, eliciting the emotional idea that any FTT whatsoever will suppress financial speculation while redirecting money from bad to good uses is not the right strategy. First and foremost because it *cannot* preform such a miracle, and defenders of the *status quo* can easily dispel this misconceived virtue of the FTT once more.

First, the FTT should correctly be presented as *one* instrument, among others, in the general reform of financial markets and institutions. Therefore, the focus should be on its intrinsic economic rationale and technical design, which should be kept distinct from the uses of its revenue. Insisting on the many valuable things that can be done with the FTT revenue will not overcome the arguments of those who argue that it is a useless or harmful tax. On the grounds of the economic rationale of the FTT, we should start from the fundamentals.

A good point to start from has been suggested by the well-known financial economist at Exeter University (UK) Sheri Markose: *financial risk has become like industrial pollution*. Perhaps it is not by chance that the term *toxic assets* has been coined. In the typical handbook of Public Economics one can invariably find the example of a factory that pours its by-products into a river flowing nearby thus damaging the village lying along the river. The example introduces the chapter on *negative externalities*, the negative effects on third parties exerted by an individual's economic activity, which is in turn in the part of the handbook devoted to the correction of market failures. It is perhaps useful to recall why this is an example of a market failure. To put it simply, the fact is that the market price at which the factory's gadgets are sold include all direct production costs (labour force, capital, raw materials, etc.) but not the cost of the use of the river as a rubbish dump. This cost is (at least) the utility loss of the village community deprived of a clean river. Hence the gadgets' market price is lower than it should be, whereas the volume of production and sales is "too high" - in a very precise sense. How can the village people convince the factory owners that their loss of a clean river is (at least) worth some money?

Though not the only one, a possible solution is that the government charges a tax on sales of the factory's gadgets. The aim is that the tax is (partly) transferred to the sale price to an extent that replicates the "shadow cost" of the use of the river. The expected effect is higher price, and hence lower demand, production and pollution. The tax revenue can also be transferred back to the village people as a compensation. All this is well-known at least since the milestone treatise on *Welfare Economics* (1920) of the great British economist Arthur C. Pigou. The kind of taxes described above are also known as Pigouvian Taxes (nowadays they have become popular as "carbon taxes" as they have been largely applied in environmental regulation).

Is there any connection between the river pollution and financial risk? According to the theory of efficient financial markets, no. In fact, the price of risky financial products, the theory says, embodies the market assessment of risk, which is entirely transferred to the buyer. If the buyer actually suffers losses, these are his/her own private business. Also, financial risks can be insured against (which is why derivative markets are so esteemed by experts unlike the vast majority of people). Hence, in this ideal market, prices allocate risk efficiently among private subjects, risk is never "too much", no externalities arise, and there are no good public reasons to interfere with market prices.

The world financial crisis tells us an entirely different story, the opposite story indeed. Almost all learned reconstructions of the disaster agree on the points that 1) buyers and sellers of financial products have created "too much risk", 2) the market prices of these products were dramatically wrong, in that they grossly understated their riskiness, 3) there has been an unprecedented growth of production and trade of these products, and hence of the total mass of risk (the so-called *systemic, undiversifiable risk*), 4) derivative and insurance markets have contributed to, and have been swept up by, this general mispricing as they have alimented the most dangerous financial illusion: the disappearance of risk (the fact that I have insured my house does not reduce the risk that it burns to the ground; if anything, the risk may *increase* due to moral hazard). On top, negative externalities have been pervasive by way of *financial contagion*, the process whereby toxic assets have spread all over the world, and defaulting intermediaries have infected their interconnected partners.

Each of these phenomena has in turn been the result of deeper faults in the system, but they clearly indicate that eventually a gigantic market failure occurred, one which is better understood upon reading the example of the polluting factory in the handbook of Public Economics than the efficient market hypothesis in the handbook of Financial Economics. In the face of this evidence, it is the sceptical who should explain why a financial Pigouvian Tax cannot even be conceived.

The implicit premise of most defenders of the *status quo* is that free financial markets are always and everywhere efficient; hence, it is trivial to warn that any fiscal wedge will make all of us worse off. As far as I can remember, I never heard a serious argument against the FTT that cannot be extended to any other tax. Yet taxes may be a necessary evil in a less than ideal world. I only touch one classical argument: the FTT may be counterproductive as it is transferred on prices (the final small savers pay for it), and it reduces transaction volumes (the market is less liquid). Well, these are precisely the expected and desired effect of any Pigouvian Tax. Final buyers of financial products may not be happy to pay more and buy less, but this is the means to have them take less risk, given that the market (or their financial supplier) is unable to do that. The market may well be less liquid, but if the liquidity which dries up is the toxic one, the result is socially desirable (the toxic liquidity has in fact turned out to be a tragic mirage).

Another objection may be that high transaction volumes may not be a direct source of financial pollution by themselves. This may be true in theory, but in practice pre-crisis data show that high volumes are a good proxy for *accumulation* and *diffusion* of excess risk. I only recall that between 2006 and 2009 high frequency transactions grew from 30% to 60% of total exchanges. On the eve of bankruptcy, officials found in Bear Stearns's books some 150 million open positions *vis-à-vis* 5000 counterparties, figures that had been steadily growing over the previous years (source: J. Cassidy, *How Markets Fail*)

It may be added that, if these are the aims, a FTT is precisely the right instrument rather than a profit tax on the financial sector as a whole, which would not discriminate between polluters and non-polluters. Hence, one further point of strength of the FTT is that it may be a substitute for other taxes. Finally, the FTT with a clear, and limited, rationale can be communicated more easily, and may provide a transparent and consistent source of public funds for financial stability and safety purposes.

These considerations do not mean that introducing a FTT is panacea for all financial evils. First, a lot of thorny technical problems should be addressed carefully. Second, the FTT can only be one tool in a wider array of new regulation and control instruments and institutions. However, time is ripe for a farewell to the promise of the Shangri-La of self-regulating financial markets, and to tackle financial pollution seriously.

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[1] Janeway Lectures, Princeton University, then published in 1974, *The New Economics One Decade Older.*
