A tax to suit the times

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Rescuing Greece will be expensive. And if Greece is not the end of the story, the costs will be mind-numbing.

Thus it is no coincidence that European Commission president Jose Manuel Barrosso has reached into the bag of possible ways to pluck the taxation goose with minimum squawking, and has rediscovered the Tobin tax. This would be a small tax imposed on all financial transactions. This idea has been around for forty years, first suggested by James Tobin in the aftermath of the collapse of fixed exchange rates in 1971.

The central attraction is that even a tiny sliver of tax on the huge volume of financial transactions would seem to raise serious revenue. President Barrosso mentioned a figure of $55 billion per year. Economists have generally pooh-poohed this sort of simplistic calculation, arguing that unless the taxes were imposed universally (which is very hard to achieve), financial transactions would shift to some locality outside the jurisdiction, thus raising no revenue while distorting the natural path of transactions.

The 2008 global financial crisis brought some re-thinking of the economists' usual dismissive analysis of the Tobin tax. The GFC put the basic tenets of the efficient markets hypothesis under serious question. No longer was it part of the accepted wisdom that restrictions on transactions would harm the process of price discovery in free markets. Financial markets clearly did a poor job in pricing risk before the crisis, and played a disruptively volatile role once the crisis unfolded.

More recently, high-frequency trading (now a large part of all modern financial exchanges) is hard to defend as a necessary part of the price-discovery process. The usual rationale that it adds liquidity to the market rings hollow as it is clear that this sort of liquidity evaporates as soon as markets come under pressure.

Thus the criticism that a Tobin tax would reduce transaction volume no longer wins the argument. Indeed, Tobin was well ahead of his time in arguing that the very purpose of such a tax was to slow the transaction flow: to 'put sand in the wheels' of excessive international capital flows, which had been an important part of the breakdown of the fixed exchange rate Bretton Woods system.

The more practical counter-argument may still win the day: it is almost impossible to make the tax universal. Financial transactions, footloose in nature, will quickly gravitate to whichever countries decide to opt out. It's true that leading international financial centres such as London already have a stamp-duty transaction tax. But it is small enough to not outweigh the advantages London has as an established financial centre with complex legal infrastructure and intellectual capital.

Any attempt to pluck serious amounts of tax from the banking goose would cause more than squawking. At every mention of new prudential measures or capital requirements, bankers have threatened to move shop to less demanding jurisdictions. Thus a Tobin tax seems an unlikely answer to the eurozone's current problems.

This proposal does, however, serve as a reminder of the tax's attractions. If the idea that the Tobin tax is a huge revenue raiser is abandoned, and if it could be placed on an activity which is generally regarded as socially useless or even harmful, it just might get up one day.

The performance of the financial sector in the GFC leaves the sector open to the charge that some of its functions are 'socially useless'. Bill Gates has been commissioned by the G20 to investigate a tax on financial transactions, with the revenue devoted to international aid. Nor is the financial sector the only target. In a carbon-conscious world, international air travel is often mentioned as a suitable case for Tobin tax treatment.

Is the Tobin tax an idea whose time has come? Not in relation to the urgent needs of the eurozone crisis. But nor has it disappeared from the wider debate.

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