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Taxing the Speculators

By PAUL KRUGMAN

Should we use taxes to deter financial speculation? Yes, say top British officials, who oversee the City of London, one of the world's two great banking centers. Other European governments agree — and they're right.

Unfortunately, United States officials — especially Timothy Geithner, the Treasury secretary — are dead set against the proposal. Let's hope they reconsider: a financial transactions tax is an idea whose time has come.

The dispute began back in August, when Adair Turner, Britain's top financial regulator, called for a tax on financial transactions as a way to discourage “socially useless” activities. Gordon Brown, the British prime minister, picked up on his proposal, which he presented at the Group of 20 meeting of leading economies this month.

Why is this a good idea? The Turner-Brown proposal is a modern version of an idea originally floated in 1972 by the late James Tobin, the Nobel-winning Yale economist. Tobin argued that currency speculation — money moving internationally to bet on fluctuations in exchange rates — was having a disruptive effect on the world economy. To reduce these disruptions, he called for a small tax on every exchange of currencies.

Such a tax would be a trivial expense for people engaged in foreign trade or long-term investment; but it would be a major disincentive for people trying to make a fast buck (or euro, or yen) by outguessing the markets over the course of a few days or weeks. It would, as Tobin said, “throw some sand in the well-greased wheels” of speculation.

Tobin's idea went nowhere at the time. Later, much to his dismay, it became a favorite hobbyhorse of the anti-globalization left. But the Turner-Brown proposal, which would apply a “Tobin tax” to all financial transactions — not just those involving foreign currency — is very much in Tobin's spirit. It would be a trivial expense for long-term investors, but it would deter much of the churning that now takes place in our hyperactive financial markets.

This would be a bad thing if financial hyperactivity were productive. But after the debacle of the past two years, there's broad agreement — I'm tempted to say, agreement on the part of almost everyone not on the financial industry's payroll — with Mr. Turner's assertion that a lot of what Wall Street and the City do is “socially useless.” And a transactions tax could generate substantial revenue, helping alleviate fears about government deficits. What's not to like?

The main argument made by opponents of a financial transactions tax is that it would be unworkable, because traders would find ways to avoid it. Some also argue that it wouldn't do anything to deter the socially damaging behavior that caused our current crisis. But neither claim stands up to scrutiny.

On the claim that financial transactions can't be taxed: modern trading is a highly centralized affair. Take, for example, Tobin's original proposal to tax foreign exchange trades. How can you do this, when currency traders are located all over the world? The answer is, while traders are all over the place, a majority of their transactions are settled — i.e., payment is made — at a single London-based institution. This centralization keeps the cost of transactions low, which is what makes the huge volume of wheeling and dealing possible. It also, however, makes these transactions relatively easy to identify and tax.

What about the claim that a financial transactions tax doesn't address the real problem? It's true that a transactions tax wouldn't have stopped lenders from making bad loans, or gullible investors from buying toxic waste backed by those loans.

But bad investments aren't the whole story of the crisis. What turned those bad investments into catastrophe was the financial system's excessive reliance on short-term money.

As Gary Gorton and Andrew Metrick of Yale have shown, by 2007 the United States banking system had become crucially dependent on "repo" transactions, in which financial institutions sell assets to investors while promising to buy them back after a short period — often a single day. Losses in subprime and other assets triggered a banking crisis because they undermined this system — there was a "run on repo."

And a financial transactions tax, by discouraging reliance on ultra-short-run financing, would have made such a run much less likely. So contrary to what the skeptics say, such a tax would have helped prevent the current crisis — and could help us avoid a future replay.

Would a Tobin tax solve all our problems? Of course not. But it could be part of the process of shrinking our bloated financial sector. On this, as on other issues, the Obama administration needs to free its mind from Wall Street's thrall.

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