THE NEW PERSPECTIVES ON THE TOBIN TAX. COULD IT PROVIDE ANY SUPPORT FOR THE EURO-AREA?[85]

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Abstract: This paper aims to present a new approach of the Tobin tax concept under the circumstances of the current economic and financial crisis in the Euro-Area, raising new questions concerning its applicability and potential support in preventing speculative foreign exchange transactions.

JEL classification: G01, G15, G18

1. INTRODUCTION. THE THEORETICAL BASIS OF THE TOBIN TAX

The concept we commonly use under the name of „The Tobin Tax" has been first advanced by the late Yale professor and Nobel laureate economist James Tobin (1978). It makes reference to a tax aiming to reduce disruptive speculation on foreign exchange markets by raising the cost of engaging in this type of transactions. Based on previous literature and concepts - the Tobin tax develops an earlier proposal made by Keynes (1936) in the book, The General Theory of Employment, Interest, and Money. Keynes envisaged the application of a small transactioning tax on all stock exchange transactions aiming to diminish instability of stock markets. This idea emerged on the background of the 1929 crisis caused by the stock market crash and the substantial negative consequences. Lacking formalism, strong regulation and taxation, the Wall Street seems to have been the source for both early 1929 and actual crisis. As de Grawe states - the Tobin-tax has become the most popular proposal for controlling capital movements as it discourages short-term capital movements (usually considered to be destabilizing by the proponents of the tax) but keeps longterm capital flows relatively unaffected. (deGrawe 2000)

The applicability of the Tobin tax as it has been initially created by its author, aims all spot transactions on the foreign exchange market and it aims a short term effect as it has to be financed within shorter periods, and different category transactions such as trade and long-term capital investments should be affected in a negligible manner. The envisaged level ranges from 0,1% to 1%, with a 0,2% to 2% tax cost for each exchange and a 48% to 480% per year if transacted every business day, 10% to 100% per week and 2,4% to 24% every day. The Frankel (1996) approach and understanding of the Tobin tax points out the fact that it penalizes short-term investments more the shorter the horizon. One of the key issues in making this

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instrument efficient is establishing an appropriate rate of taxation, also given the evolutions of the financial market during the period of time from the settlement of the concept. The increasing trading volume in derivate and new derivative instruments, and the application of the Tobin tax in a limited manner to spot transactions will again determine a reorientation from traditional spot transactions to derivative instruments. Goodhart (1996) and Bird,Rajan (2000) point out that also futures, swaps and options should also make subject for taxation as they represent alternative ways through which a speculator cango long or short of a currency without going through the spot market. The Eichengreen, Tobin and Wyplosz (1995) paper, perhaps the most cited work when analyzing the Tobin tax, supports Tobin's arguments for "putting grains of sand in the wheels of financial markets", and for the fact that this type of measure could present itself with welfare implications for those cases when these markets determine shocks on labor and commodity markets. The central aim of the tax is to discourage speculative short-term attacks and excessive volatility as shocks manifestation, and according to these authors it represents the second-best alternative on the foreign exchange market horizon.

As main hypothesis for the settlement of the Tobin tax, speculation had to be qualified in terms of influence and positive or negative phenomena. Argumentations around the negative or positive effects of a speculative environment range from Keynes (1936), to Milton Friedman (1953) and Dornbusch and Frankel (1987). Keynes (1936) describes the speculative behavior as a "beauty contest". The goal of the speculators is not to estimate the intrinsic market value but to beat the market – or how Keynes would have said – to '*anticipate what average opinion expects the average opinion to be' and to 'guess better than the crowd how the crowd will behave'*. The equilibrium role of speculation has been invoked and also its contribution towards determining a fundamental value of the traded titles and towards driving the market down to its warranted price. Even though, the key element seems to been an accurate estimate of the equilibrium price by the speculators, which is not always a straight forward one. The classical logical argumentation falls in the area of a fall whenever the price is above the equilibrium and vice versa. In case the equilibrium does not exist or cannot be detected directly by the market participants, it might be rational to assume that the price will move up further. In fact, this precisely what has caused the recent economic and financial crisis – the speculative bubble, also as a proof of the fact that usually, short-term oriented speculators perform better compared to market participants who base their buying-selling decisions on fundamental data such as the assumption of a properly estimated equilibrium price. Thus, beyond anything else, this type of speculation seems to be the one causing real destabilization and disequilibrium on the international financial market, and this is just the short-term perspective. The long-term assessment may prove speculation as stabilizing on a larger scale of the international foreign exchange market. Under these circumstances of speculation, while it does not require the market participant to evaluate the fundamental of the exchange rate, the Tobin tax should work as automatic detection mechanism for the equilibrium price by discouraging short term speculation, and thus, becoming superior to other financial market limitation instruments (Menkhoff and Michaelis (1995)).

2. THE NEW CRISIS PERSPECTIVE

Ever since the debut of the actual economic and financial crisis, authorities have tried to find the appropriate solutions that could diminish or further away the negative effect of this phenomenon. But what if we should first envisage the causes in order to treat? The actual application of a measure such as the Tobin tax is highly dependent on the identification of the real sources of the disequilibrium out-burst. The uncontrolled movements of the foreign exchange market have certainly been the cause of the late 2007 bursting bubble. But beyond that, different other previously manifested causes may add up. Failures of international financial markets may also be generate by panic, moral hazard and adverse selection due to asymmetric information (Haberer 2003).The financial sector, as the main source of the actual crisis has played an important role in the development, growth and convergence process in Europe, especially for the central and eastern European EU acceding countries. From this very perspective, the EU is a rather particular case, both in terms of the regulation of the financial market, and also in terms of the evolution of the crisis, its impact, required instruments and future prospects. The main features of the EU crisis, independent of the source, have been alarming debt levels/shares, and also high deficits in terms of public budget. The rather recent liberalization of capital accounts in many European countries, and specifically in the central and Eastern part of the continent, has also been a major contributor to the specificity of the crisis and to implications drawn from the financial side. Given the emerging markets, economic theory suggests that capital should flow "downhill", from relatively capital- intensive economies to relatively less capital-intensive economies, given that the marginal return on capital is expected to be larger in the latter parts of the world. (Gardó and Martin, 2010) During the last couple of years the CESEE countries were good examples of emerging market economies which imported large amounts of capital in order to finance their growth and convergence process (see Abiad, Leigh and Mody, 2007).

The table below provides data describing the foreign exchange turnover in daily averages for 2010 – the most recent reporting period, in order to settle a scale for the transactioning level, by category of instruments. The criterion employed here is a regional one meant to depict the imposing mass for the Tobin tax and estimated income results

Table no. 2. Regional FX turnover by instrument. (in billions of US dollars)

Region	Spot	Outright forwards and FX swaps	Currency	Options	Total
North America	491	423	10	42	966
Western Europe	916	1,672	29	163	2,780
Asia-Pacific	361	743	16	38	1,159
Eastern Europe	30	38	0	0	68
Latin America	21	20	1	1	42
Africa and Middle East	13	25	1	2	41
All regions	1,832	2,921	57	246	5,056
Adjustment for - cross-border double counting	342	-681	-14	-39	-1,075
Global turnover	1,490	2,240	43	207	3,981

*Source: *** BIS – TriennialCentral Bank Survey Report on global foreign exchange market activity in 2010, 2010, p.18*

The Western European area accounts for a majority in spot transactions where the levy of the financial tax could be located.

3. THE TOBIN TAX APPLICABILITY AND SUPPORT FOR THE CURRENT ISSUES OF THE EURO AREA

As a response to recent developments as a consequence of the economic and financial crisis, the Euro-area has been trying to put into place appropriate instruments meant on one side to provide a minimum financial back-up for the affected member states, and on the other side to insure the prevention of future disequilibrium. The European Financial Stability Facility (EFSF) is one of the instruments meant to safeguard stability in the Euro-area, within the EcoFin framework previously settled and in strict accordance with the aim of providing support to member states in need of financial back-up.

As part of the EFSF we encounter the following employable instruments in case of requirement from Euro-area member states: loans provided to countries in financial difficulties, intervention in the debt primary and secondary markets, based on an ECB analysis and conclusions in respect of the existence of exceptional financial market circumstances and risks to financial stability of the Euro-area, action based on a precautionary programme, finance recapitalizations of financial institutions through loans to governments. (EFSF statute)

Aiming to fulfill its supportive mission, the EFSF issues bonds or other debt instruments on the capital markets and has been backed by guarantee commitments from the euro area Member States for a total of €780 billion and has a lending capacity of €440 billion. From the credit ranking perspective, the EFSF has been assigned by Moody’s and Fitch Ratings the best credit ratings -(Aaa), (AAA) and AA+ rating from Standard & Poor’s.

The second support instrument - The European financial stabilization mechanism (EFSM) provides assistance to Member States where: a Member State is experiencing, or is seriously threatened with, a severe financial disturbance; the financial disturbance or threat of financial disturbance is due to events beyond the control of the Member State concerned – according to the European Commission. Up to this point, the EFSM has granted financing to Portugal and Ireland based on its two main requirements – the assessments of the states needs, and an economic and financial adjustment programme and on the Council’s decision. The amount directed towards these two economies is presented in the table below.

Table no.1.Overview on EFSM funding and loan disbursements

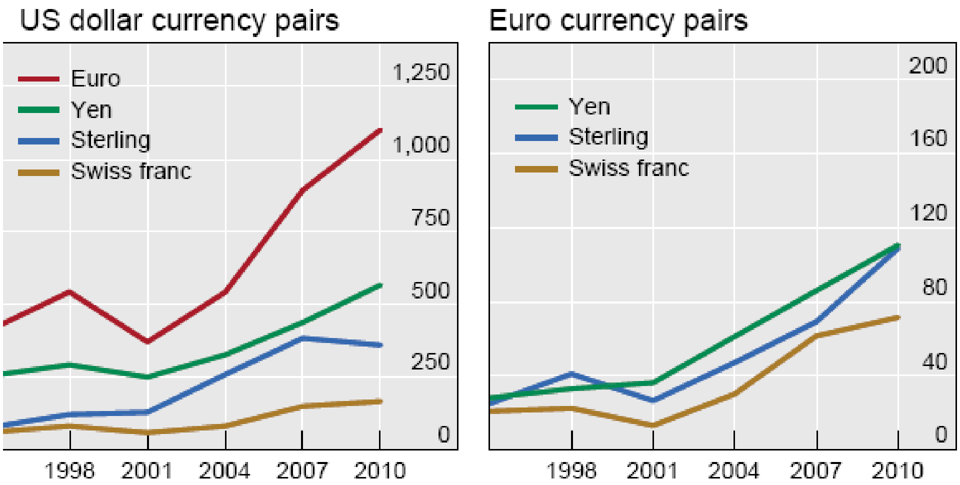
Amount	Maturity	Raised on	Loan beneficiary	Disbursement on
€ 5.0 bn	5 yr	5 Jan. 2011	Ireland	12 Jan. 2011
€ 3.4 bn	7 yr	17 March 2011	Ireland	24 March 2011
€ 4.75 bn	10 yr	24 May 2011	€ 3 bn for Ireland, € 1.75 bn for Portugal	31 May 2011
€ 4.75 bn	5 yr	25 May 2011	Portugal	1 June 2011
€ 5.0 bn	10yr	14 Sept. 2011	Portugal	21 Sept. 2011
€ 4.0 bn	15yr	22 Sept. 2011	€ 2 bn for Ireland; € 2 bn for Portugal	29 Sept. 2011
€ 1.1 bn	7yr	29 Sept. 2011	€ 0.5 bn for Ireland; € 0.6 bn for Portugal	6 Oct. 2011
€ 3.0 bn	30 yr	9 Jan. 2012	€ 1.5 bn for Ireland; € 1.5 bn for Portugal	16 Jan. 2012
€ 3.0 bn	20 yr	27 Feb. 2012	Ireland	5 March 2012

Source: The European Commission

Under these circumstances, where could it be, the place and the role of the Tobin tax? Could it act a financing instrument also? Could it raise capital at the same time with limiting the financial market instability due to speculation?

Faced with recent problems, the EU, through the voice and representation of the European Commission also charged with budgetary decisions, has included a levy on financial transactions, more commonly known as a "Tobin tax" for the period 2014 – 2020. According to estimates of the EU commission, this instrument is envisaged to support around a third of the EU budget (Uppal R., 2011).Is this perspective unanimously supported by member states? Assessments and positions are rather differentiated. Germany, Spain and France largely agree on the levy of financial transactions as being a suitable solution – as France has already stated officially through a positive vote in the national assembly. In anticipation of a delocalization of its financial activity towards more de-reglemented areas, the United Kingdom has strongly opposed the idea of the implementation of a financial levy. With a presumably constant EU budget of 1000 billion euros for the next few years, the expected contribution of the Tobin tax, as far as EU authorities see it, should raise to around 300 billion euros.

Beyond that, the budget generated income level may also be retrieved in terms of the Euro share on foreign exchange market. The most common foreign currency pairing is presented in the chart below according to 2010 transactioning. USD/EUR remained by far the dominant pair (with a 28% share), followed at some distance by USD/JPY with a slight increase to 14% of turnover. The USD/GBP pair continued to retreat from its 2004 peak to a 9% share or about the level reached in pre-euro 1998, but the EUR/GBP pair gained almost 60% in absolute terms. (BIS, 2010)



*Source: *** BIS – TriennialCentral Bank Survey Report on global foreign exchange market activity in 2010, 2010, p.15*

Figure no.1. Reported foreign exchange market turnover by currency pair

Majorly, a pro or against decision position comes from an estimative analysis of costs and benefits, but that is not all. The *medicine* role of the Tobin tax also largely depends on the state of the financial market at a certain moment in time. While normal development intervals are more likely to support free financial market and an auto-regulatory mechanism from within, crisis intervals, on the other hands, could require, also on a financial level as on regular markets, a higher level of control regulation or even restrictions. Thus, the EU perspective on the Tobin tax does not limit to the foreign exchange market control, but it also focuses on the income creation effect for the EU budget

4. CONCLUSIONS

Even if the Tobin tax may not be a universal medicine against instability and crisis episodes, at least for limited periods, it may represent a feasible instrument if politically agreed upon over a determined transactioning area and if correctly adjusted, dimensioned and appropriately implemented.

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