European leaders are seriously considering a Tobin tax, which would put a small levy on financial transactions, thereby dampening trading. But will the tax do as much as its proponents hope?

The popularity of the tax (named for the late Nobel laureate economist James Tobin, for whom its aim was to reduce exchange-rate volatility in currency markets) reflects widespread animus directed at the financial sector, but it far exceeds any real benefits that the tax would deliver. Nonetheless, elected officials find a Tobin tax highly appealing, because it could blunt criticism and divert attention from fundamental, but politically paralyzing, problems surrounding economic policy, particularly budgets, debt, and slow growth.

A Tobin tax does have benefits, even if it cannot address enough of the problems that afflict financial markets today. A tax on stock transactions encourages longer-term holdings. It taxes liquidity, which many believe is overly abundant. It encourages fundamental analysis of a company’s operations, and some advocates hope that a Tobin tax would push firms themselves to focus even more on long-term value.

Moreover, a Tobin tax moves financial traders – talented people with strong work habits – into other activities, which (policymakers hope) will benefit the economy more. And, if financial innovations like derivatives and short-term repurchase agreements have made markets more volatile and fragile, a Tobin tax could help to stabilize and strengthen them.

While these are worthy goals, there are good reasons to believe that the tax would not achieve most of them. Long-term stockholders alone do not encourage a firm’s managers to manage for the long term. In fact, to the extent that dampened trading diminishes market feedback to firms and their directors, it could make managers complacent. Traders might stop trading, but shareholders still might not conduct more fundamental, long-term analysis: the rise of index funds, which hold a broadly-diversified swath of the entire stock market, reflects this trend toward stockholder passivity.

Lowering volatility and sopping up excess liquidity can be beneficial, but there are risks here as well: regulators can easily overshoot the mark, leaving financial markets with weakened capacity for price discovery and too little liquidity.

That leaves the hope that a Tobin tax would induce high-IQ financial traders to do something else, with higher net benefits to society. If trading today is not helping to move capital to its highest and best use, reallocating inefficiently employed financial talent could yield big benefits. But is too much trading really a critical economic problem?

Consider the following. The financial crisis erupted in 2008 when mortgage-backed securities were revalued at much less than what they had been thought to be worth. The problem was not that these securities were ferociously traded (most were not, and thus were not the kind of security that a Tobin tax would hit hard), but rather that everyone in financial markets revalued them at the same time. That left the financial institutions that held mortgage-backed securities in much weaker condition, and several failed. At the time of the crisis itself, however, the main
problem was not too much trading, but too little, as liquidity dried up for many financial transactions.

Still, in one area, a Tobin tax could provide an unmitigated benefit. Many of the largest, most precarious financial institutions now finance themselves via repo: they buy a long-term security (often government debt) and sell it, promising to buy it back the next day for a slightly higher price.

Dampening the repo market could be economically useful, because this funding has proven to be unstable: Bear Stearns and Lehman Brothers used repo heavily in ways that made them unable to withstand investment reversals elsewhere in their business. The same was true of MF Holdings last fall. Stronger, longer-term financing might have allowed these firms to survive. If a Tobin tax induced financial institutions to finance themselves with more longer-term debt and less overnight repo, it could play a significant stabilizing role.

While it is well known that a Tobin tax would have little effect on markets unless all major financial centers adopted it, what is true of markets is not necessarily true of financial institutions. If, say, French President Sarkozy wanted to stop too-big-to-fail French financial institutions from transacting in ways that weaken them, a Tobin tax on their transactions, wherever in the world they occurred, could work; the tax would affect the institutions, even if it could not shape worldwide markets.

To be sure, markets might move those transactions from France and from French financial institutions, and, if the regulators erred – because the business was profitable and not destabilizing – French institutions would lose out. But, if the regulators were right, the French institutions would be more stable. If the Tobin tax aims to strengthen institutions (instead of altering markets), it could bite hard, even without the buy-in of every major country.

Overall, there is not much to be said against the tax (other than what is said against all taxes), and something to be said for it. But it does not help to solve major financial problems, and those that it does address (short-term, overnight financing) could be dealt with more directly, with a more focused tax, better rules governing those transactions, and improved prudential regulation.

As of now, Europe’s Tobin tax proposals are not well targeted. Sound transactions would be taxed along with destabilizing, overnight financing of fragile financial institutions.

A Tobin tax does, however, allow elected politicians to look like they are doing something useful – which they are, but without addressing more serious economic problems.

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