Tobin Tax: Notes for UPSC Economics

In this article, we give you a brief about the concept in economics called the Tobin Tax, named after economist James Tobin.

The information from this article will be useful in the IAS Exam.

What is the Tobin Tax?

A Tobin tax, which was suggested by the Nobel Memorial Prize in Economic Sciences Laureate economist James Tobin, was originally defined as a tax on all spot conversions of one currency into another. The initial concept of the tax put a penalty on short-term financial ventures into another currency. Rather than the consumers paying a tax, the Tobin tax would be paid by market players as a method for controlling the stability of a country's currency.

The idea behind the Tobin Tax was to develop a way to manage the exchange rate volatility. James Tobin came up with two solutions for this issue:

1. Move towards a common currency, monetary and fiscal policy coupled with economic integration.
2. Make efforts towards greater financial segmentation between nations, permitting greater autonomy for central banks and governments in financial policies.

In the development of his idea, Tobin was influenced by the earlier work of John Maynard Keynes on general financial transaction taxes.

Evaluation of Tobin Tax

One of the main economic hypotheses raised in favour of financial transaction taxes is that such taxes reduce return volatility, leading to an increase of long-term investor utility or more predictable levels of exchange rates. The impact of such a tax on volatility is of particular concern because the main justification given for this tax by Tobin was to improve the autonomy of macroeconomic policy by curbing international currency speculation and its destabilizing effect on national exchange rates.

Although Tobin had said his own tax idea was unfeasible in practice, Joseph Stiglitz, former Senior Vice President and Chief Economist of the World Bank, said, on October 5, 2009, that modern technology meant that was no longer the case. Stiglitz said the tax is "much more feasible today" than a few decades ago when Tobin recanted.

However, on November 7, 2009, at the G20 finance ministers summit in Scotland, Dominique Strauss-Khan, head of the International Monetary Fund, said "transactions are very difficult to measure and so it's very easy to avoid a transaction tax.

In January 2010, the feasibility of the tax was supported and clarified by researcher Rodney Schmidt, who noted "it is technically easy to collect a financial tax from exchanges ... transactions taxes can be collected by the central counterparty at the point of the trade, or automatically in the clearing or settlement process.

Relevant Question Regarding Tobin Tax for UPSC

What is the alternative name for Transaction Tax Schemes like the Tobin Tax?

The alternative term for these broader tax schemes is Robin Hood tax, due to tax revenues from the (presumably richer) speculator funding general revenue (of whom the primary beneficiaries are less wealthy).

What is the difference between hedging and speculation?

A brief difference between hedging and speculation is given below:

- Hedging protects an existing investment against unforeseen price changes, while speculation takes on the additional risk the investor could have avoided.
- Hedging is a means to manage or limit price risk, while speculation actually relies on taking a risk for profit (and is in this respect similar to gambling)
- Hedging protects against price changes and makes them less relevant to the overall price of outputs sold to the public, while speculation incurs risk to make a profit specifically from price volatility.