Economic & Political Weekly
New Delhi, 7 January 2017

Time for a Neo-Tobin Tax

The Prime Minister's speech at the inauguration of the National Institute of Securities Markets (NISM) campus outside Mumbai on 23 December 2016 seemed to have spooked certain players in Dalal Street enough to trigger a 0.9% drop in the Sensex, thus dragging it to a seven-month low. Although the Finance Minister Arun Jaitley has since gone on record to dispel further selling off and attributed the reaction to a minor misinterpretation, the Prime Minister's speech itself comprised other elements, which are worthy of attention.

Far from advocating textbook neo-liberalism, the rarity of the domestic bond and capital markets in the funding of infrastructure was spoken about, the importance of regulating unfettered markets was highlighted, as well as the need for merging technological development with agriculture was mentioned. More specifically, the underdevelopment of the domestic capital markets warrants further attention. The Prime Minister himself said that most of the infrastructure funding in India stemmed from the government or from banks. In order for capital markets to contribute significantly, funds would need to be locked in for a long period, something that foreign institutional investors (FIIs) would normally be averse to. Such a requirement mimics a regulation that the previous Reserve Bank of India (RBI) Governor, Raghuram Rajan had imposed on 5 February 2015, where he stated that foreign portfolio investors investing in debt instruments would have to lock them in for a minimum of three years.

The need for imposing a restriction on the lock-in period for investments is clear. Yet, the implementation is more challenging since such a limitation might have a tendency to simmer down the bullish sentiment, and the policy might end up being counterproductive. In this light, it would seem more prudent to use price policies instead of quantitative restrictions. The Tobin tax, first proposed by American economist James Tobin in the 1970s seems to be a useful mechanism to achieve this goal.

The original tax suggested by Tobin was a tax on all spot conversions of currencies. The idea behind the tax was to discourage substantial speculative behaviour. Thus, according to Tobin, if an international consensus could be reached wherein each country was to levy a certain tax that would discourage volatile capital inflows, economies would be far less susceptible to fickle investor sentiment. Revenue generation is not, however, a primary objective behind the Tobin tax. This structure as an instrument was also proposed back in February 2015 by prominent academicians as a feasible method for discouraging high volatility of foreign inflows. Moreover, in his book, *Global Crisis Recession and Uneven Recovery,* former RBI Governor, Y V Reddy lays stress on the Tobin tax and how it might be conducive to the Indian scenario.

Since its inception, the definition of the tax has been subjected to no minor degree of distortion owing to the fact that several countries have imposed levies which have been categorised under the ambit of Tobin tax. And yet, the experience has been ambiguous at best. Thailand, Colombia and Chile have not produced any substantial results. The result is also not clearly positive for Brazil and Sweden. Malaysia stands as the only country where the desired results were obtained and that too owing to the substantial stress that its public policy had put on the implementation of the same. It would thus seem that the feedback for this policy would depend largely on the endogenous conditions prevailing in an economy at a certain period. Thus, although the ideal behind the policy is in tandem with requirements that the Prime Minister mentioned, the feasibility still remains a hurdle.

In his book, Reddy mentions that although the Tobin tax has not garnered much success historically, there is little scope for such a policy to be toxic in the long run. Moreover, he finds that an economy which has imposed an almost benign tax structure in its securities transaction tax framework ought to work towards putting into execution a structure that levies a substantially high tax rate on short-term capital gains than in the long term. Holders of participatory notes ought to be kept on a position that is in parity with other investors such that they are not given undue advantage. This would also provide substantial scope for preventing round-tripping of money through tax havens and generation of new black money.

It has been widely held by academicians and policymakers now that excessive financialisation of an economy would bring with it systemic risks and this might have considerable impacts on the economy as a whole. In this light, in order to avoid the "tail wagging the dog," levying of a neo-Tobin tax on certain segments of the financial sector may do more good than harm. Such a measure could go a long way in bringing sound, long-term capital into the economy, thus broadening the horizon for an underdeveloped bond market and hence, ensuring further pervasion of the same into key sectors.

Utso Pal Mustafi
MUMBAI