A tax on short-term debt would stabilise the system

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The idea of imposing a tax on financial transactions, also called the Tobin tax after the economist who first proposed it, is back in vogue. It has strong political appeal, catering to demands to punish banks for the crisis they have bestowed. It satisfies the political need to do something to avoid a repeat of the crisis. And, at a time of fiscal crisis, it provides an easy way to raise revenues without increasing income taxes. Last Friday, European Union leaders urged the International Monetary Fund to consider such a tax.

In spite of this strong endorsement, a Tobin tax has big shortcomings. First, it is hard to implement. If the tax is just on equity and bond trading, it will move most of the trading to the futures and options markets. If it extends to all traded derivatives, it will favour derivatives contracts that are not traded or new contracts created to avoid it. Second, if not applied homogeneously throughout the world, it will divert trading offshore. Do we really want all trading to move to Bermuda? Finally, the idea that such a tax would avoid a repeat of the crisis has not been proved.

According to its backers, the aim of the tax is to deter “speculative” behaviour, leading to lower volatility in asset prices. Alas, there is no evidence that it would do this.

The idea of a tax to deter socially undesirable behaviour is a good one. But if we want to prevent a repeat of 2008, we need to target the behaviour most likely to have caused the crisis. It was not caused by excessive trading, but by excessive risk-taking. What transformed a relatively small loss on subprime mortgages into a crisis was the enormous leverage of financial intermediaries, much of it short term.

As Gary Gorton and Andrew Metrick argue in a recent paper, the crisis was precipitated by a run on repos, overnight secured loans. When subprime losses hit financial intermediaries, short-term lenders, fearing bankruptcy, refused to renew lending. This progressive withdrawal of funds forced intermediaries to sell more assets, depressing prices further. It was similar to a traditional bank run, except initiated by short-term lenders.

Anticipating this risk, why did financial intermediaries choose to borrow so much in the short term? Because it allowed them to borrow more and borrow more cheaply, increasing profits. Short-term lenders, meanwhile, felt confident that they could get out of troubled companies in time. But while the exit option is available to each lender individually, it is not available to all lenders together. When all short-term lenders try to leave, not only can they not do so, they precipitate a crisis. In other words, the incentives to borrow short-term exceed what would be optimal from a social point of view.

This is a typical situation where a tax can fix the problem. By taxing the use of short-term debt (let us say with maturity of less than a year), we discourage both excessive leverage and use of short-term leverage, preventing a crisis.

If short-term debt is so dangerous, why did we not see its pernicious effects before? When inflation was high and volatile, short-term debt was both costly and risky because it carried a huge refinancing risk. The last 30 years of low and stable inflation took away those costs. The Fed’s low interest rate policy created huge incentives to borrow short.
Intense competition and compensation that rewarded high performance handsomely did the rest: they made it irresistible to borrow short term, with big systemic consequences.

Some people have argued that the best way to solve the problem is to eliminate the tax deductibility of debt. However, the real problem is not debt but short-term debt. In a close to zero interest rate environment, the elimination of tax deductibility will have the perverse incentive of favouring short-term debt (on which the lack of deductibility will have almost no impact) over long-term debt.

A better solution is a tax on short-term debt, especially short-term debt of financial institutions. A 1 per cent tax on our outstanding short-term debt would raise $21.5bn (€14.6bn, £13.2bn) annually just among the top nine institutions. This is not going to fix our budget problems but would be enough to pay for the surge in Afghanistan. Most importantly, it could stabilise our financial system and prevent a new crisis.

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