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The Introduction of an International Financial Transaction Tax

"We task the IMF to prepare a report for our next meeting with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system."

Leaders' Statement – The Pittsburgh Summit September 24–25, 2009

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The proposal by James Tobin

1. The initial proposal of an international transaction tax was formulated by Keynes who in 1936 pointed to the need to strengthen the weight of long-range fundamentals in stock market price fixing. It is Prof. James Tobin however who first developed a comprehensive proposal for a global tax on spot transactions across currencies. The proposal was elaborated in the early 1970s, following the end of the Bretton Wood Gold Standard regime and the flotation of the US dollar, and was formally presented in 1978.

2. Contrary to what is often reported about the 'Tobin Tax', James Tobin's initial concern was not to curb financial speculation as such, but to restore government autonomy in monetary policy (and particularly in fixing domestic interest rates), and hence increase economic sovereignty at national level. Free movement of capital across currencies and flexible exchange rates regimes following the end of the Bretton Wood regime, he claimed, had given way to speculative attacks on currencies and more broadly to short term market behaviour un-related to economic fundamentals.

3. The resulting increase in volatility of prices, particularly in exchange rates and interest rates in "normal periods" constrained the monetary policy of governments, particularly with regard to setting the domestic interest rates and hence the real economy's access to long term and cost effective financing. Speculation may also have real economic consequences in the short term via its impact on international trade. A rapid appreciation of a currency impacts the terms of the trade, Tobin citing as an example the surprise appreciation of the US dollar against the Yen in the early 1980s which "nearly destroyed" the US car industry. Volatility in market prices became an issue over the short-term but also over the long-term. Small short-term speculation produces over the long run "long swings" in asset prices which departed significantly from their theoretical equilibrium levels. Such "overshooting" in prices can lead

to speculative bubbles for any asset that can be traded on an exchange: exchange rates and with that, interest rates, but also listed equity, commodities, bonds, etc.

4. Tobin warned against a widening gap between "super-efficient" globally integrated financial markets and the real economies where adjustments are "sluggish, transactions, are costly, transportation is slow […], and expectations fuzzy". Tobin's aim was to "throw some sand in the well-greased wheels" of international financial markets to "slow down" and align capital flows with economic fundamentals and the real economy horizon. Compared with alternative options such as fixed, floating, or adjustable pegs exchange regimes, national capital controls, a global tax would effectively reduce volatility – and hence restoring room for manoeuvre in monetary policy – and have a symmetrical and neutral effect in reducing financial flows with minimum impact on international trade.

5. Tobin's proposal was to establish a 0.5% tax on all forms of exchange transactions of currency, be it local or cross-border. In effect the tax rate would be inversely proportional to the frequency of transactions. A 0.5% tax on a round-trip (that is purchase then resale) within 3 months would translate into an annual 4% tax rate and the cost would fall rapidly for longer span to become negligible beyond 1-year span, not to speak of foreign direct investment. The tax burden would increase inversely below 3-months: an investor with a holding period of a day (and assuming 240 trading days a year) would require 287.7% annual return on investment before tax to obtain a 4% after tax return. As such, the tax would wipe out much of the daily trading in currency transactions that is generated not on the basis of economic fundamentals, but short term market expectations.

6. Tobin did address – but only in general terms – the allocation of the revenues generated by such tax. A 0.5% tax on the USD1.2tr traded daily in 2001 would amount to USD1.4tr on an annual basis, in 2007 the same calculation would lead to annual tax revenues of USD3.7tr, that is a bit less than half the size of the assets under management of US pension funds each year. These are however rough estimates that do not factor in the reduction in transactions that would follow mechanically the introduction of the tax. In addition, most recent proposals include lower tax rates in the range of 0.01 to 0.1% generating annual revenues in the range of USD10bn to USD1tr depending on the perimeter and after adjustment for the reduction in volume induced by the tax. Tobin suggested allocating the revenues to the IMF for the purpose of financing development; the irony of this proposal is that the IMF ranks among the most virulent opponents to the Tobin tax. For James Tobin however the discussion on allocation of the revenues was subject to a trade-off: "The more the tax succeeds in the economic objectives that primarily motivated me, and the handful of economists who agree with me, the less revenues it collects for worldwide good works."

7. Many of the issues surrounding the tax were discussed by James Tobin at a meeting organised by the CLC and the TUAC prior to the Halifax G7 Summit in 1995. Report of the roundtable is posted on the website of the TUAC.

The views of the IMF and OECD

8. Both the IMF and the OECD have been consistently sceptical on the desirability and practicality of a Tobin Tax. Several IMF papers, such as a 1996 article by the Fiscal Affairs Department, have argued why such global tax "won't work". The OECD has not departed

from this view and in June 2002 published a stand alone chapter in its Economic Outlook publication summing up the arguments by the IMF and the OECD against at the Tobin tax.

- **Frequent or short term trading is not a bad thing, it contributes to risk management and compensate for market opacity.** Frequent traders and higher levels of daily trading can reduce volatility by increasing distribution of risks, and for markets that lacks transparency on pricing as is the case of foreign exchange markets it contributes to the "price discovery" process (i.e. one needs to buy or sale to actually know the market price), and hence facilitate risk management by investors.

- **A Tobin Tax would increase market volatility (by reducing frequent trading).** There is no evidence that a Tobin tax would reduce currency exchange volatility. In fact such tax would increase it. Any reduction in trade volume would not discriminate between good trades (i.e. arbitrage that has stabilising effects by reducing interest rate spreads) and bad trades. Less trading volume concentrates risks and hampers investors' management of risk and hence increases the cost of capital. For shallow markets in particular (those with few daily transactions) the tax would create liquidity problems and would increase volatility dramatically; because there would be less frequent traders, the markets could be subject to abrupt price movements due to a single transaction.

- **Volatility does not impact trade.** The beneficial effect of reducing cost of insurance against volatility of a Tobin tax on trade and investment has not been proven. Theoretically there is no consensus on the impact of higher volatility on trade, and empirically the negative impact appears not to be large.

- **The Tax would dry up the derivatives market.** To be effective, the tax would need to apply to derivative products that precisely aim at ensuring investors against volatility risks. In doing so the tax risks drying up the derivative market or at minimum would higher the cost of insuring possibly by more than they would be lowered by any reduction in volatility.

- **It would weaken market discipline on governments.** Because the tax would reduce the ability of markets to respond instantly to policy changes or announcements, it would reduce market discipline on policy makers and governments.

- **Implementation could well prove insurmountable**. If not, trading would tend to migrate to other, non-taxed jurisdictions, which may well be less regulated than existing venues, or participants could use other financial vehicles to achieve the same end.

- **Allocating Tax revenues would become a problem on its own.** If it were possible to implement the Tax, the revenue yield from such a tax could be significant but would rapidly decrease in good part because the tax base itself is likely to fall. Even so, earmarking the revenues from such a tax for specific, albeit highly legitimate, expenditures, like ODA, would seem to be "neither economically efficient, nor politically optimal".

- **Political feasibility.** The political conditions to implement and enforce such tax are not currently in place.

Short term trading and the risk of speculative bubbles

9. Not all of the above arguments against the Tax are of equal importance. With the new G20 process that has emerged from the crisis, political feasibility and implementation cannot be given as reasons for dismissing the idea. The currency market is highly concentrated in few countries. Half of all daily foreign exchange transactions around the world are conducted in the UK (34%) and in the US (16%) alone. If one adds Switzerland, Singapore, Hong Kong, Australia, Japan, France & Germany, it is 83% of all daily exchange transactions that take place in nine jurisdictions only (all of which being G20 members except Singapore and Switzerland). The very existence of national taxes on financial transactions in the UK and Brazil should provide evidence for a workable implementation – an issue raised by President Obama when he met union leaders in Pittsburgh. Also, the fear of a massive capital and transaction flight to offshore centres and tax havens is largely overstated, even more with the current agenda on tax havens. Similarly, it would be hard to argue that allocation of revenues would be problematic, considering ODA levels relative to GDP or the explosion in public debt and deficits in the OECD countries as a result of the crisis.

10. Fundamentally, the core of the debate on the Tax lies with the link between trading and volatility. Have short term trading and free flows of capital indeed fed into the recurrent formation of speculative bubbles in the past decades and into asset price "overshooting"? Or to the contrary and as the IMF and the OECD argue, have they facilitated risk management and dispersion, better price discovery and moving faster to market equilibria? In October 2009, WIFO, the joint Employer-Labour governed Austrian Institute of Economic Research, published a stock taking paper on the pros and cons of a financial transactions tax applied not only to currency transactions (Tobin's perimeter) but to any forms of transactions (equity, bonds, other debt instruments, tradable and non-tradable derivatives). The paper concludes that "observations suggest that financial markets are characterized by excessive liquidity and by excessive volatility of prices over the short run as well as over the long run. In other words: strong and persistent deviations of asset prices from their fundamental equilibria ("overshooting") are rather the rule than the exception". Excessive volatility and recurrent price overshooting is observed on many markets, the paper citing the USD/EUR exchange rate, Oil price, and US/UK& German equity indices as examples.

11. The paper further points to the inherently speculative nature of the derivative products that were introduced to precisely hedge investors against volatility of the underlying assets: "the spectacular rise of derivatives trading cannot be caused by hedging activities because the volume of derivatives transactions is just much too big to be accounted for by hedging". In the same vein, it questions the role played by "technical trading": the "overall transaction volumes stems from technical trading since this practice uses data of ever higher frequencies (trading becomes progressively "faster"). At the same time, technical trading is unrelated to market fundamentals".

State of discussion in 2009

12. The Tobin tax has surfaced on several occasions in the international policy debate, particularly – and not surprisingly – in the aftermath of major financial crises. That was the case in 1995-1996 (following the Mexican crisis in 1994), in 1998-1999 (Asian crisis) and in 2001-2002 (Dotcom stock-market bubble). An important literature has developed since 1978. Among proponents, Tobin has collaborated extensively with Barry Eichengreen and Charles

Wyplosz in the 1990s. Some modified proposals have been introduced – such as a two-tier tax system – but basically the original project by James Tobin (who passed away in 2002) has not evolved substantially with the years.

13. Exception to this is the tax rate as noted above (current proposals are closer to 0.1% or below, as compared with the original 0.5% rate). Also, the perimeter of the tax – moving beyond currency transactions to include all derivative and OTC transactions, if not any form of transactions – and the importance given to allocation of the revenues in some fora have overshadowed to some extent the initial aim the tax: to restore sovereign monetary policy. The potential revenues that would be generated by a global tax indeed have gained wider interest in the past two decades, particular among civil society organisations and development aid agencies. In particular the global tax has been seen as a "ready at hand" option to compensate for the failure of OECD governments in raising ODA to 0.7% of their GNI. In 2004, the French government released a feasibility report on the introduction of global taxation instruments for financing development including a tax on financial transactions, as well as on airlines, on multinational companies' profit, and on weapon sales. This report led to the launching in Paris in 2006 of the "Leading Group on Solidarity Levies" now involving 55 countries. The Group met in Paris on 23 October 2009 – including high level representation from the UK and France – and agreed to the creation of a "Taskforce on International Financial Transactions for Development" which should report back in May 2010.

14. On unions side, several publications and campaigns have in the past addressed the creation of a global financial tax, for example the ICFTU "Trade Union Proposals for Reforming the International Financial System" of 2002 and before that the TUAC report on a Round Table Discussion with James Tobin in 1995 and various TUAC–OECD LMP meeting reports since then. More recently, in August 2009 PSI, UNI and BWI joined hands in the Asia Pacific region to launch a campaign for an International Solidarity Levy, while the EI and the PSI are preparing a Global Unions report on Corporate Taxation and Resources and Resources for Quality Public Services. Also, in October 2009 the ETUC endorsed a policy position in favour of "a harmonised European tax on particular financial transactions".

15. The issue is back on the agenda with the current global crisis and the G20 Process in particular. Alongside civil society and social movements which have been campaigning for the Tobin Tax for some time, the ITUC, the TUAC and the Global Union Federations have made the introduction of an international transactions tax a stand alone policy in their submissions to the G20 Summits in Washington (Nov. 08), London (April 09) and Pittsburgh (Sep. 09). Despite the renewed visibility of the global tax, it has yet to enter a formal international agenda. In particular it was not considered as a policy option on the occasion of the 2002 UN Summit on Financing for Development and the multilateral process that followed. The latest report by the UN Stiglitz Commission on the crisis (Sep. 09) does not tackle the issue explicitly and, it seems, would rather favour a "global deposit insurance" funded by fixed fees by banks or a tax on "all cross-border deposits".

16. As noted at the Pittsburgh Summit however, the G20 Leaders tasked "the IMF to prepare a report for our next meeting with regard to the range of options countries have adopted or are considering as to how the financial sector could make a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system." This can be read as a first opening to a global tax on financial transactions within a high level intergovernmental forum. It remains to be seen whether this

interpretation is shared by the IMF. At a press conference Strauss-Khan clarified that this mandate was “not the over simplistic Tobin tax that has been advocated by some in the past, but having some special funding coming from the financial sector”. To which Lipsky added that the IMF would limit the study, due in May 2010, to an international version of deposit insurance schemes as they exist in most countries. From there the study, Lipsky added, would “look more broadly across the financial system” on “how mitigation costs should be borne” and whether it would be “right to place a burden specifically on the financial system”.

17. As the cost to taxpayers of the financial crisis becomes more acute in the months and years ahead, it appears that an international tax on financial transactions must be part of the response. The Plenary session is invited to note the information in this paper which will be part of the work programme of the TUAC on economic policy in close cooperation with the ITUC.

Source

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