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Tobin tax: could it work?

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Whenever development financing is discussed these days, it is hard to avoid mention of the Tobin tax. Generally, the question people ask is whether it would be feasible, even desirable, to put a tax on global capital flows to finance development. The issue also came up for discussion at the UN Financing for Development Conference, in Monterrey (Mexico) in March 2002, when heads of state and the major international institutions met to discuss ways of reducing global poverty.

That the original purpose of the tax was not development hardly matters, though for the record, the tax was proposed in 1972 by the US economist, James Tobin, as a way of throwing sand in the wheels of international finance, and so combat market volatility. Basically, it would involve taxing currency market transactions. What may explain its appeal to some governments and NGOs is that even a very small tax rate imposed on such a large tax base as the foreign exchange market would, at least in theory, yield sizeable revenues to finance 'global public goods', like the environment, health programmes, poverty reduction, etc. Estimates of between US$50-250bn per year have been waved about, based on tax rates of between 0.05% and 0.25%. (To put this into perspective, official aid from the 21 OECD countries that form the Development Assistance Committee came to $53.7bn in 2000.)

But how realistic are these figures? A look at the structure of currency markets suggests they are probably exaggerated. Currency markets are characterised by a lot of intra-day clearing and netting, a feature likely to be fostered by the growing use of electronic broking. A survey of foreign exchange market activities (spot, forward, swaps) released by the Bank for International Settlements in October 2001 estimated the daily turnover at $1,210bn in 2001, down 19% from $1,490bn in 1998. The introduction of the euro (12 currencies becoming one), the growing share of electronic broking in the spot interbank market and consolidation in the banking industry appear to explain this fall. The trend may continue, which would raise a problem from the outset: that of a declining tax base.

Also, despite the growing role of electronic brokering, trading between dealers (rather than with other financial institutions or with non-financial customers) makes up more than half of foreign exchange market turnover. The largest part of the daily transactions are done for purposes of hedging between traders to avoid over-exposure in currencies accumulated from deal-making. Hedging activities are known as 'hot potato trading', as any speculative selling of, say, the US dollar could leave the seller with a supply of unwanted euros, which he or she will then try to off-load to other dealers. The practice helps to spread risk more evenly. The Tobin tax would discourage hedging, though, because its multiple transactions would each be taxed. Consequently, the tax base of daily foreign exchange transactions would shrink.

There is also the question of how to impose the tax to maximise revenue. Many deals are done throughout a single day and are settled together when the markets close. Taxing these settlement sites where the currencies are transferred to the books of the central banks may seem the simplest approach. However, according to a key study by Professor Peter Kenen, the tax should be levied on each trade at the dealing sites. It would then capture the total value of the deals, whereas settlement involves netting the day¡¦s transactions, and so would produce a lower taxable amount.

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Tax avoidance would probably grow too, further reducing the Tobin tax's ability to yield revenue. Two principal types are likely: first, the migration of the foreign exchange market to tax-free jurisdictions; and second, the substitution of tax-free for taxable transactions.

Migration would occur unless all jurisdictions with major foreign exchange market turnover adopted the tax. Trading could be drawn to new sites, such as an offshore tax haven somewhere. This migration could be prevented by a punitive tax on all transactions with that haven, enabling trading to continue with complying sites. This penalty would reduce the risk of a migration flood gate being opened by a 'first mover'. But it would only work with small jurisdictions. If one of the larger established markets, like Frankfurt or Hong Kong for instance, did not adopt a Tobin tax, plenty of dealers would shift to that tax-free market and trade among themselves, without being affected by any punitive measures. The tax base would clearly be eroded as a result.

To stop substitution of taxable foreign exchange transactions by tax-free ones, the Tobin tax would have to cover several financial instruments and keep up with new ones created to circumvent the tax. For instance, a tax on spot transactions can be avoided easily by using short-dated forward transactions. So, these would have to be taxed as well. And as swap transactions combine a spot with an offsetting forward contract, they would also have to be taxed. Moreover, taxing currency swaps alone will not do, as a foreign exchange transaction can be replicated by a combination of a currency and treasury bill swap, thereby evading the currency market (and the tax) to some extent.

Even assuming the Tobin tax was feasible to operate, would it be economically desirable? Put another way, would it lower distortions in international capital markets and encourage less volatility, or crisis-prone investment and help alleviate poverty?

The original purpose of Mr Tobin's proposal -- to reduce 'excessive' exchange rate volatility -- has moved to the background. After all, the size of the monthly changes in the relative value of key currencies has not grown in line with the rise in international capital mobility of recent decades. On the contrary, as we have seen, the Tobin tax might well reduce the liquidity of foreign exchange markets. And because it reduces hedging activities in the market, it would encourage more pure speculation and hence lead to more, not less, volatility.

Most observers are less concerned with short-term volatility (which can be hedged) than with longer term misalignment of exchange rates, notably those of emerging markets. Such misalignment may at times be rooted in boom-bust cycles of private lending and investment to developing countries. But the Tobin tax would not be large enough to counter these cycles, whose risk-adjusted returns would, given the sudden swings from euphoria to panic, require extremely high tax rates to balance them.

There are other uncertainties too: can we be sure that political leaders today and tomorrow would use their Tobin tax receipts for development? Is the tax administratively feasible to collect? How would it affect aid? Even before the UN Conference on Financing for Development in Monterrey, the US and the EU had pledged to increase their development assistance. Yet most agree that despite these efforts, the financing gap to achieve the Millennium Development Goals (mainly to halve poverty by 2015 -- see references) will not be reached without other financing measures. Nor is it likely that a Tobin tax would deliver the results everyone would like. Still, the debate has added new urgency to the search for tools to improve our development funding in efficient and meaningful ways. There may be other approaches: some have talked of tax incentives for companies investing in poverty reduction, or building special trust funds with new issues of special drawing rights (SDRs) by the International Monetary Fund. Like the Tobin tax, such ideas must be closely scrutinised.

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