CURRENCY TRANSACTIONS TAXES:

A BRIEF ASSESSMENT OF OPPORTUNITIES AND LIMITATIONS

A policy memo prepared for the session, "Can currency transaction taxes stabilize financial markets?," at the New Rules for Global Finance conference on the "Tobin Tax," January 16, 2003, Washington, DC.

Ilene Grabel[1]
Associate Professor of International Finance
Graduate School of International Studies
University of Denver
Denver, CO 80208, USA
Phone: 303/871-2546; FAX: 303/871-2456; email: igrabel@du.edu

August 2003

[1] I thank the participants at the January 2003 New Rules conference for their helpful comments on this policy memo. I also thank Peter Zawadzki for excellent research assistance.

1. INTRODUCTION

Recently there has been a surge of interest in the use of transactions taxes to stabilize financial markets and to reduce the potential for financial crisis by curbing speculation, asset price misalignment and financial volatility.[2]

Keynes made the case for a securities transactions tax (STT) in 1936. A number of heterodox economists have renewed the case for STTs [e.g., Pollin *et al*., 2001; Crotty and Epstein, 1996; Spahn, 1995]. Tobin's [1974, 1978] well-known extension of the STT to foreign exchange markets has received a great deal of support of late [e.g., Arestis and Sawyer, 1999; Felix, 1999; Haq *et al*., 1996; Wade, 1998]. The currency transaction tax (CTT)--or the Tobin tax as it is more commonly known--is a modest *ad valorem* tax on all spot transactions in foreign exchange. Tobin [1996] amended his original proposal to encompass forward and swap transactions as well. Empirical studies of CTTs estimate that the ideal tax rate would be quite low, ranging from .1% to .25% [Felix and Sau, 1996].

Among transaction tax proposals, none has received as much attention as proposals for CTTs. Indeed, at the May 2002 conference of the coalition "New Rules for Global Finance," the CTT was a topic of intense debate in the group's discussions of alternatives to neoliberal financial models. The most recent New Rules conference was organized in response to calls by participants at the May 2002 event for further discussion of recent research, political support and activism with regard to CTTs around the world. The breadth and international character of participants and speakers at the January 2003 event demonstrates the salience of CTTs to various constituents. The World Institute for Development Economics Research/United Nations University is also working on a similar track by commissioning studies of CTTs and STTs (along with other types of taxes) as part of their program on "Innovative financing for development" [Grabel and Nissanke, 2003 is one such work].

In this brief policy memo, I review the possible achievements and limitations of CTTs. I conclude by arguing that CTTs can be a component of what I term a "developmentalist financial architecture." This term refers to a financial system that promotes equitable, stable and sustainable economic development.[3] However, I conclude that CTTs *alone* are an inadequate means to address many of the most pressing financial and investment concerns in developing countries.

2. OPPORTUNITIES PRESENTED BY CTTS

A. CTTs have the potential to raise revenue

The potential of CTTs to raise revenue must not be overlooked. Given the likely incidence of CTTs, they are progressive taxes. The progressive incidence of CTTs renders them a desirable

[2] Grabel and Nissanke [2003], Dodd [2002], Hinman [2002] and Palley [2001] provide useful reviews and analyses of the central issues.
[3] Grabel [2002, 2003b] discusses the concept of a developmentalist financial architecture.

form of taxation.[4] Numerous researchers have recently developed forecasts that reveal the potential of CTTs (and STTs) to raise significant revenues. For example, Grabel and Nissanke [2003] find that a global CTT has the potential to raise between 16 and 35 billion US dollars in one year (using currency market data for 2001).

Many advocates of CTTs suggest that the tax revenues can be used for socially-desirable purposes, such as those that promote economic development and/or provide needed finance to the United Nations or global environmental projects. This is clearly a desirable aspect of CTTs. For instance, Kaul and Langmore [1996] suggest that CTT proceeds could be collected by a centralized authority charged with extending concessionary development loans.

B. CTTs can promote modest reductions in some short-term trading and attendant currency and financial volatility[5]

CTTs could reasonably be expected to reduce some "day trading" in currency markets. This is because the annualized cost of even a very small tax may be prohibitive in the case of habitually active traders, especially during tranquil times when expected returns on these trades are modest. In this case, CTTs could reduce some of the volatility introduced by short-term currency trading (and resultant distortions in currency prices) to the extent that churning by some investors is discouraged.

There are two compatible means for enhancing the ability of CTT to reduce currency market volatility. Joint implementation of a CTT and a STT would enhance their potential to reduce currency (and other types of financial) market volatility. A STT can reinforce the stabilizing effect of a CTT by increasing the cost of investor flight, as Crotty and Epstein [1996] have observed. Investor flight might be discouraged by this conjoint taxation.

A variable STT-CTT would further enhance the potential of these measures to reduce currency (and other types of financial) market volatility. Spahn [1995, 1996] is the best-known proponent of a two-tiered tax. During tranquil times, low transaction taxes might be maintained. High transaction taxes (and an additional exit tax) would be imposed on investors whenever policymakers deemed an economy vulnerable to crisis (perhaps because a "tripwire" or other indicator revealed vulnerability). With knowledge of this variable tax structure, investors might be less likely ex-ante to engage in activities that aggravate various types of financial risks (such as currency risk or investor flight risk). In any case, the activation of a prohibitively high tax (as a speed bump) might discourage some investors from liquidating their portfolios.

3. LIMITATIONS OF CTTS

A. CTTs will not significantly influence the composition of investment or prevent financial crises

As argued above, a CTT (even in conjunction with a STT) would at best modestly reduce some currency and financial market volatility. But CTTs are not a sufficient tool for preventing

---

[4] Baker [2001] discusses this issue at some length. See also Palley [1999] for other public finance arguments in support of the Tobin Tax.

[5] This section and the discussion that follows draw on Grabel [2003a].

financial crises of the sort that have become all too common in developing countries. CTTs are not an effective means for reducing the fragility risk that stems from widespread participation in speculative activities and the currency and/or repayment risks inherent in risky financing strategies (such as those that involve locational or maturity mismatch). This is the case for two reasons.

First, CTTs are not designed to dampen speculation in all of the sectors of the economy that are prone to bubbles. For example, speculation in real estate and construction contributed significantly to fragility risk in the East Asian countries that were party to the 1997-8 financial crisis. Second, even in those sectors that do fall under the authority of CTTs (and even STTs), the presence of a tax is unlikely to reduce speculation dramatically [Akyuz and Cornford, 1995 p. 188].[6] This is because the ideal tax rate is rather low relative to the expected profits associated with speculation. Hence, a low CTT (or even a low STT) would not be sufficient to undermine the attractiveness of activities and financing strategies that aggravate fragility risk, particularly in the context of rising expectations during an economic boom.

For the reasons advanced above, CTTs (and STTs) are also not the best means for curbing the financing and investment strategies that render developing countries vulnerable to large-scale investor flight and/or sudden, large currency appreciations or depreciations. The presence of a relatively small tax on currency (or securities) sales would be unlikely to discourage investor exit if investors have reason to fear massive capital losses due to declining securities prices and/or a significant currency depreciation [Crotty and Epstein, 1996; Dodd, 2002, 2003; Palley, 2001:74]. Thus, CTTs (or STTs) would neither prevent the accretion of activities that create currency and investor flight risk, nor would they prevent the kind of herding behavior that exacerbates these risks in the context of investor flight. Moreover, CTTs cannot reduce the risk of contagion from financial crises that originate elsewhere.

In sum, traditional CTTs (and STTs) would not have prevented the accretion of risks that culminated in the East Asian crisis of 1997-98.[7] CTTs would also not have prevented the implosion of the Argentinean economy in 2002 or the spillover effects of this crisis on Uruguay and Paraguay. It is important to note, however, that a dual or a variable STT-CTT has a greater potential to reduce financial volatility and mitigate the severity of financial crisis than does a traditional CTT.

B. CTTs will not enhance macroeconomic policy autonomy or reduce the power of the financial community vis-à-vis policymakers in the developing world

Policymakers in developing countries face constraints on policy autonomy for several reasons. First, they often find themselves compelled to implement contractionary macroeconomic policy because it is seen as necessary to attract and retain the international private capital flows on which they depend. In practice, this policy bias has proven highly detrimental to economic growth and living standards. In addition, a contractionary policy bias privileges the economic interests of the financial community over other groups within society (such as the poor).

---

[6] But see Felix [1999, p. 10] for an alternative view.
[7] This contrasts with Wade who writes that the tax "might have slowed the build up to the crisis" [1998, p. 1545].

Second, during crises the pressure to implement contractionary macroeconomic policies is especially severe. In this context, contractionary policy is often seen as necessary to rescue a collapsing currency and slow the pace of investor flight. Third, following a crisis, an especially contractionary policy regime may be deemed necessary in order to induce private investors to return to the country.[8] Fourth, assistance from the IMF following financial crises often comes at the price of having critical domestic economic policy decisions vetted by the institution. This shift in power to the IMF is highly problematic insofar as the institution has a highly undemocratic governance structure and is dominated by the USA.

CTTs do not offset any of these constraints on policy autonomy.[9] This limitation stems from the inability of CTTs alone to protect developing countries from large-scale investor flight and/or financial crises.

4. Concluding thoughts

Proponents of a developmentalist financial architecture have reason to offer support to CTTs because of their potential to raise revenue and to inaugurate modest reductions in currency market volatility. However, advocates of CTTs also have reason to recognize its important limitations, and to press for more fundamental reforms of the global financial architecture. Indeed, many supporters of CTTs envision the tax as a complement to programs of far-reaching progressive financial reform [e.g., Jetin, 2002]. In this regard, it is critical to promote measures that enhance the right of developing countries to impose capital controls, and to support policies that encourage the provision of stable sources of long-term finance to developing countries and those that facilitate a reduction in the burdens of external debt [for examples of such policies, see Chang and Grabel, forthcoming, 2004:chs.9-11; Grabel, 2003a].

References

Akyuz, Y. and Cornford, A. 1995. International capital movements: some proposals for reform, Michie, J. and Grieve Smith, J. (eds), *Managing the Global Economy*, Oxford, Oxford University Press

Arestis, P. and Sawyer, M. 1999. What role for the Tobin tax in world economic governance?, in Michie, J. and Grieve Smith, J. (eds), *Global Instability: The Political Economy of World Economic Governance,* London, Routledge, 1999

Baker, D. 2001, 'Why Do We Avoid Financial-Transaction Taxes?' *Challenge*, May-June, 44(3), pp. 90-96.

[8] However, evidence from the Asian crisis countries shows that this strategy does not work.

[9] James Tobin [1974, 1978] discusses the issue of policy autonomy in some depth, though not specifically in the developing country context. On this matter, Tobin argued that a CTT could restore "some fraction of short-run [policy] autonomy." However, he went on to explain that "it will not, should not, permit governments to make domestic policies without reference to external consequences" [Tobin, 1978:158]. I thank Randall Dodd for discussion of this issue. By contrast, financial reforms that are more far-reaching in scope (such as capital controls) stand to play a significant role in enhancing policy autonomy in developing countries.

Chang, H-J and Grabel, I, forthcoming, *Reclaiming Development* (provisional title), London, Zed Press.

Crotty, J, and Epstein, G, 1996, 'In Defence of Capital Controls', in L Panitch, 1996, ed, *Are There Alternatives? Socialist Register 1996*, London, Merlin Press, 118-49.

Dodd, R. 2002, 'Primer: Transactions taxes, or the Tobin Tax,' Derivatives Study Center, December, www.financialpolicy.org/DSC%20Primer%20TT.htm.

---. 2003, "Lessons for Tobin Tax advocates: The politics of policy and the economics of market micro-structure," Derivatives Study Center, January, www.financialpolicy.org.

Felix, D. 1999. 'Repairing the Global Financial Architecture', *Foreign Policy in Focus*, Special Report, no. 5, September

Felix, D., and Sau, R. 1996. On the revenue raising potential and phasing in of the Tobin tax, in Haq *et al.* (eds), 1996

Grabel, I. 2003a, 'Averting Crisis? Assessing Measures to Manage Financial Integration in Emerging Economies', *Cambridge Journal of Economics*, vol. 27, no. 3, 317-36.

----. 2003b, 'International Private Capital Flows and Developing Countries,' in *Rethinking Development Economics*, Ha-Joon Chang editor, London: Anthem Press, pp. 325-45.

---- 2002, 'Towards a Developmentalist International Financial Architecture,' presentation at the 'NGO Dialogue with Delegates of the Second Committee of the UN General Assembly on the Financing for Development (FfD) Follow-up', UN, NY, 7 November 2002.

Grabel, I. and M. Nissanke, 2003, 'An assessment of the revenue potential of taxes on international private capital flows, securities and currency transactions' a paper prepared for the World Institute for Development Economics Research/United Nations University project on "Innovative Financing for Development."

Haq, M. ul, Kaul, I., and Grunberg, I. (eds) 1996. *The Tobin Tax: Coping with Financial Volatility*, Oxford, Oxford University Press

Hinman, M. 2002, 'Primer on Tobin Taxes,' A report prepared for Oxfam America.

Jetin, Bruno. 2002. 'From the currency transaction tax to capital controls: How to re-establish a hold on globalized finance? A response to Paul Davidson's critique.

Kaul, I. and Langmore, J. 1996. Potential uses of the revenue from a Tobin tax, in Haq *et al.* (eds), 1996

Palley, T. 1999. 'Speculation and Tobin Taxes: Why Sand in the Wheels Can Increase Economic Efficiency,' *Journal of Economics*, 69(2), pp. 113-26.

----. 2001. ‘Destabilizing Speculation and the Case for an International Currency Transactions Tax,’ *Challenge*, 44(3), May-June, pp. 70-89.

Pollin, T., D. Baker, M. Schaberg, 2001, ‘Securities Transaction Taxes for US Financial Markets’, Political Economy Research Institute, University of Massachusetts-Amherst.

Spahn, P. 1995. ‘International Financial Flows and Transaction Taxes’, IMF Working Paper, Fiscal Affairs Department, No. 60, June

----. 1996. ‘The Tobin Tax and Exchange Rate Stability,’ *Finance and Development*, June.

Tobin, J. 1974. *The New Economics One Decade Older,* Princeton, Princeton University Press

---. 1978. ‘A proposal for monetary reform,’ *Eastern Economic Journal*, IV(3-4), pp. 153-59.

---. 1996. Prologue, in Haq *et al.* (eds), 1996

Wade, R. 1998. The Asian debt-and-development crisis of 1997-?: causes and consequences, *World Development*, vol. 26, no. 8