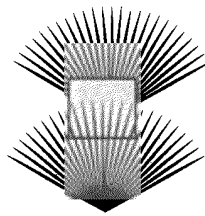


# **THE TOBIN TAX**

## **Coping with Financial Volatility**



Edited by  
Mahbub ul Haq  
Inge Kaul  
Isabelle Grunberg

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## Prologue

*James Tobin*

The publication of this book and the holding of the conference that preceded it testify to an active interest in my proposal for an international tax on foreign exchange transactions—the so-called Tobin tax. Bob Haq, once a student of mine, Inge Kaul and their colleagues deserve great credit for their initiative in organizing this project—they assembled leading experts in international economics, development, global finance and world politics. They have certainly earned my gratitude. I appreciate immensely the serious consideration the authors of these excellent papers have given the proposal. Their research and analysis have certainly advanced understanding, mine in particular, of the issues raised by the proposal, while pointing out the need for further study.

### **The proposal and its cool reception, 1972–95**

I dropped the idea of a currency transactions tax into the pool almost a quarter of a century ago—in my Janeway Lectures at Princeton in 1972 (published in Tobin 1974). The tax was on my list of measures to enhance the efficacy of macroeconomic policy. In 1977, I was

emboldened to devote my presidential address to the Eastern Economic Association entirely to it (Tobin 1978). It did not make much of a ripple. In fact, one might say that it sank like a rock. The community of professional economists simply ignored it. The interest that occasionally arose came from journalists and financial pundits. It was usually triggered by currency crises and died out when the crisis passed from the headlines.

The idea was anathema to central bankers. The most recent currency crises led reporters to ask Ottmar Issing, the economic brain of the Bundesbank, about the Tobin tax. He replied with some asperity, "Oh, that again. It's the Loch Ness Monster, popping up once more!" When I next encountered Issing, whom I like and respect, I said, "Well here I am, the Monster still."

Another source of recent and current interest in the proposal (for example, shown by President Mitterand at the World Social Summit in Copenhagen in 1994) is its potential as a generator of revenue—revenue that could be dedicated to multilateral purposes, given the probable necessity of having a tax that is implemented internationally. I had suggested this use in Tobin (1978) as a by-product of the proposed tax, not as its principal purpose.

Some of the interest in the tax at the Social Summit and on the fringes of the 1995 Halifax G-7 meeting arose from motivations in a sense similar to my own—to improve the macroeconomic performance of economies trapped by external financial pressures. These sympathizers, though their interest and support were welcome, often seemed to expect more from the Tobin tax than it could deliver.

As for economists, my friend John Williamson, himself a sceptic, remarked at the conference that only now was the idea emerging from the dismissive footnotes where it had long been consigned. I was naturally disappointed by the proposal's summary rejection. Usually, those of my professional colleagues who took any notice of it at all rejected it on the same general grounds that incline economists to dismiss out of hand any interferences with market competition, including, of course, tariffs and other barriers to international trade in goods and services. They seemed to presume that the same reasoning extends to trade in financial assets. Those who did make specific objections said the tax would damage the liquidity of currency markets. They said it would move the world's currency markets to tax-free jurisdictions, like Indonesia or the Cayman Islands. They said it wouldn't keep exchange rates from fluctuating; it wouldn't save overvalued currencies from speculative attacks and devaluations. And they said these things as if I had overlooked them.

Most disappointing and surprising, critics seemed to miss what I regarded as the essential property of the transactions tax—the beauty part—that this simple, one-parameter tax would automatically penalize short-horizon round trips, while negligibly affecting the incentives for commodity trade and long-term capital investments. A 0.2% tax on a round trip to another currency costs 48% a year if transacted every business day, 10% if every week, 2.4% if every month. But it is a trivial charge on commodity trade or long-term foreign investments. I am glad to see that this essential feature was emphasized by Eichengreen and Wyplosz, Frankel and other authors here.

An important general trend in the practical economics of regulation—in particular, the handling of environmental externalities and the safety of workers and products—has been the substitution of taxes and other quasi-price incentives and disincentives for arbitrary and absolute quantitative constraints, whether prohibitions or quotas. The transactions tax is proposed in this spirit. It handles, with built-in flexibility, problems that were formerly tackled by rigid quantitative exchange controls or financial regulations. On this score, it deserves the sympathy of modern economists.

## **Recognizing the problems of frictionless markets**

The tax especially deserves their sympathy in the light of recent changes in the climate of opinion regarding the desirability of completely unfettered mobility of financial capital across currencies. Throughout the Bretton Woods era and for a decade afterwards, official restrictions were common, even among industrial countries with sophisticated domestic financial institutions and markets. In retrospect, those years look pretty good compared with the volatilities and crises of the past 10 years (see the papers in this volume by Eichengreen and Wyplosz, and by Felix and Sau). The “Bretton Woods Commission” chaired by Paul Volcker recently expressed anxiety about world monetary turmoil.

At the annual meetings of the American Economic Association in San Francisco in January 1996, worries about excessive volatility were the main concerns of participants in a session on exchange rates, and the Tobin tax was seen as a potentially useful measure if enforcement problems could be solved (IMF 1996). Stanley Fischer, First Deputy Managing Director of the IMF and thus the Fund’s chief economist,

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agreed. He observed that exchange rate systems would still need to allow flexibility. I certainly agree with that. I have never believed that the transactions tax could make an adjustable peg system like Bretton Woods viable; the masses of private funds that can move across currencies overwhelm the funds available to central banks to defend parities.

Before 1995, the Managing Director of the IMF was promoting the idea of amending the Articles of Agreement to require complete convertibility of all members' currencies—not just of current account transactions but of all transactions, not just for foreigners but for residents too. The Mexican crisis may have convinced the IMF that there are times when some kind of sand in the wheels may be desirable. In my opinion, this, along with Fischer's willingness to consider a Tobin tax, is a fortunate change of heart. The IMF is in a good position to develop ways in which a transactions tax could work.

## **Objectives: Reducing short-term speculation and increasing national policy autonomy**

My main objectives for the tax are two. The first is to make exchange rates reflect to a larger degree long-run fundamentals relative to short-range expectations and risks. While I always recognized that “fundamentalists” would be taxed too, I thought that they were likely to have longer horizons than “Keynes-beauty-contest” speculators and therefore would be less discouraged by the tax. Consequently, I thought the tax would strengthen the weight of regressive expectations relative to extrapolative expectations. Volatility—in particular detours from fundamentals (of which Eichengreen and Wyplosz provide several examples)—would be diminished. I am glad to see this common-sense conjecture confirmed by theoretical models (see Frankel) and empirical evidence.

Evidently, 80% of foreign exchange transactions involve round trips of seven days or less. Most occur within one day. An undergraduate student of mine, upon graduating, got a job in the Chicago mercantile exchange and became assistant and apprentice to an active trader who had been an economics professor. After a few weeks the young man made bold to ask his mentor about the long-run calculations that must—necessarily he thought—govern his trades. The reply was “Sonny, my long-run is the next ten minutes.”

My second objective is to preserve and promote autonomy of national macroeconomic and monetary policies. I realize that here, as is often the case, I am opposed by a powerful tide. A widespread orthodoxy holds that financial markets know best, that the discipline they exert on central banks and governments is salubrious. Adverse capital movements should be taken as a correct judgment that internal fiscal and monetary policies are unsound and need to be changed. The example of Mexico, which is suffering cruel and painful punishments for crimes of fiscal and monetary policy it did not commit, should suffice to raise doubts about the “markets-always-know-best” proposition. The conference papers, that by Eichengreen and Wyplosz in particular, cite other cases.

## **Will the tax work in fixed- and floating-rate regimes?**

My articles of the 1970s were written in the aftermath of the demise of Bretton Woods. By 1978, there was already considerable discontent with the floating-rate regime that had replaced Bretton Woods and considerable nostalgia for fixed rates. I thought that this debate was misplaced. For one thing, the Bretton Woods system could not be restored. In the circumstances, floating rates were an improvement, certainly among the G-3 currencies—the dollar, yen and deutsche mark. At the same time, floating rates were not going to restore domestic monetary and macroeconomic policy autonomy—contrary to the more enthusiastic claims of its proponents, notably Milton Friedman.

The reasons were the increasing international mobility of massive amounts of financial capital, abetted by deregulation and by revolutions in the technologies of communication and computation. I thought that international interest rate arbitrage among money markets would be increasingly efficient and increasingly beyond the capacities of national central banks and governments—individually and in concert—to control. Yet sometimes the exchange rates brought about by these financial movements, or the interest rates necessary to prevent them, would be damaging to the affected countries. An important contribution of the Eichengreen and Wyplosz paper, and the Felix and Sau paper is that they document the relationship of intercurrency interest rate differentials to various forms of sand in the wheels—exchange controls, transactions taxes and deposit requirements.

I still do not favour restoring Bretton Woods. Adjustable pegs are not feasible. When they have to be changed, one-way speculation against a misaligned currency is bound to prevail. Devaluation is inevitable, but the process is politically and economically traumatic. Floating rates among the deutsche mark, the yen and the dollar allow economies differing in cyclical phase and in appropriate macroeconomic policies to coexist much more painlessly than pegged rates could.

The transactions tax could be helpful in either regime—fixed or floating, or in hybrids like floating bands. The numerical tax costs cited above are margins by which money market interest rates in two currencies can differ without provoking movements of funds. They provide the two central banks with some freedom to manoeuvre. The tax would not be necessary or possible within a single-currency area, whether the European Union or the whole world.

## **Will financial activity migrate to the Cayman Islands?**

There are two issues on which I have been quite uncertain and inconstant. One is the danger that the tax can be evaded by moving transactions to tax-free jurisdictions. The other is evasion by substituting untaxed transactions. On the whole, I found the papers reassuring. The studies in this volume are particularly informative on these points.

Regarding the shifting of transactions to tax-free jurisdictions, Kenen's devices seem to be feasible protections. One is to consider transfers of funds to or from such locations as taxable transactions—at penalty rates. The other is to tax at the site where the deal is made rather than at the site where the transaction occurs.

Anyway, I suspect that the danger of pushing transactions to the Cayman Islands is overblown. The already existing attractions of low-cost sites for financial dealings do not seem great enough to drive activity away from London, New York and Tokyo. I doubt that the transactions tax would move them, either. Perhaps agreement on the tax among the G-7 countries and a few other financial centres—the sites of big bank foreign exchange dealers—would suffice.

If not, the administration of a transactions tax could be assigned to the IMF, as I suggested in a recent paper. Each IMF member would be required, as a condition of membership and of borrowing privileges, to levy a tax in compliance with IMF specifications. The carrot would

be that most members, all but the jurisdictions of the major financial centres, would keep for themselves the taxes they collected. Implementing this measure would require amending the Fund's Articles of Agreement. In any case, the IMF or the Bank for International Settlements (BIS), or the two together, would be the logical administrators of other details of the transactions tax: the rate of taxation, the definition of taxable transactions and the exemption of some currencies from the tax.

## **Must all derivatives and non-cash asset exchanges be taxed?**

Defining those currency transactions that would be subject to a Tobin tax presents some difficulties. I first thought that the tax could be confined to spot transactions. I thought that derivatives need not be taxed, except at the time and to the extent that they are settled by spot transactions in currencies. The purpose of the levy, after all, is to tax transactions that affect the demand for and supply of currencies and thus the spot exchange rate. If you and I bet on the baseball World Series, the bet is a derivative of the game and does not affect the game's outcome. (When it did, as in the Black Sox scandal of 1919, there was hell to pay.) The analogy applies to future contracts and options, which are settled entirely by payments in the currency in which the value of the contract is expressed.

Thanks to Peter Kenen, I see that forwards and swaps are so much like spots that they also must be subject to the tax. For simplicity, the spot contents of such contracts could be taxed all at once.

Peter Garber points out that transactions could be settled in Treasury bills or in agreed mutual exchanges of other assets instead of in bank deposits. He warns that if the definition is broadened to extend the reach of the tax, this process could be never-ending. I am not as worried about this possibility as he is. Widening the range to cover the loophole of mutual deliveries of Treasury bills should not be too difficult. Beyond that, I am consoled by the likelihood that these exchanges can be transformed into exchanges of liquid means of payment only at costs that would probably be no less than the tax itself. If Professor Garber would like to trade his home in Providence for an Oxford don's abode for an academic year, I wouldn't cry over the loss of tax revenue that would have been collected, had the equivalent trade involved two opposite dollar-sterling conversions. I don't think such barter would



become routine speculations or hedges. What is important is to tax transactions that make the exchange rates for trade in goods and services volatile and transactions that perfect the arbitrage between the interest rates relevant to monetary policies. The objective is not to maximize revenue.

### **Should we tax only customer-originated transactions?**

Most currency transactions are made between banks and dealers. Three or four such transactions occur for every one transaction initiated by an outsider. Generally, banks and dealers are engaging in these secondary transactions in order to maintain balanced positions. If so, those transactions are not affecting exchange rates. The margins in such deals are very small, so that there is little room for a tax.

Retail transactions with customers, both non-financial individuals and businesses and other financial institutions, are a different matter. They move exchange rates, and the margins are much bigger. They could be taxed, while leaving the secondary transactions tax-free. Recognized bankers and dealers could instead be taxed on the changes in their daily net positions in currencies.

### **Revenues will be lower than expected**

In Tobin (1978), I recognized that a universal transactions tax would raise substantial revenues, and I observed that it would be appropriate to devote the proceeds of an international tax to international purposes. My specific suggestion was to augment the resources of the World Bank, but it was only an example. Raising revenue has never been my main motivation.

In recent years, the burdens on the United Nations and other international organizations have multiplied, while fiscal and political circumstances have caused national governments to curtail their financial support. As a result, the Tobin tax has been seen as a possible source of funds for international purposes. For some advocates of the tax, this is the principal motivation.

The volume of foreign exchange transactions worldwide reached \$1,300 billion a day in 1995—\$312 trillion in a year of 240 business days.

With this volume, it seems at first that even a small tax would yield mammoth revenues, for example \$312 billion a year from every 0.1% of tax. I have learned from the conference papers to expect much more modest yields, for several reasons.

First, the tax rate must be lower than I originally thought. It should not exceed 0.25% and perhaps should be as low as 0.1%. Otherwise, the tax would swamp the normal commission charged.

Second, allowance must be made for tax-induced reduction in the volume of transactions. After all, the primary purposes of the tax, in my mind, depend on just such shrinkage. As Frankel and other authors suggest, the present bank-centred organization of the market, which entails three to eight interbank transactions for every customer-bank transaction, might give way to arrangements that entail fewer taxed transactions. A market organized like securities markets would enable non-bank transactors to make deals directly with each other.

Third, if my suggestion that banks and dealers be taxed only on changes in their end-of-day open positions were adopted, only 30% of the gross volume of transactions cited above would be taxable, plus the unknown volume of taxable open positions. This is roughly the same number as would be taxable if an organized market replaced the present institutional arrangements. The revenue yield would be \$94 billion a year for a 0.1% one-way tax, and perhaps as little as half of that because of the tax-induced reduction of transactions volume.

Fourth, the actual collection of the tax could be the job of the tax authorities of member nations. In order to obtain their agreement and cooperation, it would be desirable to let the various jurisdictions retain shares of the collected revenues. For small countries, the shares could be 100%—the purpose of requiring them to levy the tax is not to gather revenue but to prevent them from setting up tax-free facilities, while undermining the tax base of the major market centres. These centres could be expected to dedicate larger shares to international purposes.

Clearly, there are difficult political problems in any international agreement under which sovereign nations levy a tax tailored to international specifications and turn over part or all of the revenues collected. It might sweeten the pill if each nation were allowed to retain at least 50% of the proceeds and to choose—among internationally agreed alternatives—where the tax revenues would go.

Several of the papers argue that the currency transactions tax is not the only possible source of revenue dedicated to international purposes, or necessarily the most appropriate source. I agree that a range

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of alternatives should be considered. A carbon tax, for example, makes a great deal of sense. I do believe that a well-functioning international monetary and payments system is a public good to which national members could legitimately be expected to contribute.

In summary, the authors of the papers differ in their verdicts on the Tobin tax; many of them are still uncertain. I am neither surprised nor dismayed. I am just pleased that the proposal is finally being seriously evaluated.

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