



TAXATION

New financial instruments for global challenges

A Tobin Tax to tame hot money and boost development.

By Peter Waldow

The promise that globalisation will bring prosperity to all has not been fulfilled. The gap between rich and poor continues to widen, not only within the industrialised and developing countries but also between the North and South. Globalisation creates some winners - but many losers, too. Mechanisms are urgently needed to create a more stable framework for development and to channel resources to where they are most needed. A tax on currency speculation promises to do just that.

In today's neo-liberal climate, the long-term problems of environmental protection, unemployment and growing poverty tend to be ignored. The tasks involved, especially in the developing world, cannot be tackled without sufficient financial resources - money that is not available

in a world economy preoccupied by privatisation and shareholder value.

There is a serious crisis of development financing. It is characterised by ever dwindling official development assistance, on the one hand (see table), and a growing need for funds for environmental and social action, on the other. The United Nations has now responded by, for the first time in its history, preparing for an international conference on "financing for development", scheduled to take place in 2002. The spectrum of topics will range from the future impact of public and private capital flows on the South through to institutional reforms in the global financial system. Yet even at this early stage of conference preparations, it is already clear that the key to any breakthrough will centre on the creation of effective financial instruments.

Official development assistance (ODA) of DAC member countries

Year	Current \$ billion
1992	58.3
1993	55.5
1994	59.6
1995	59.1
1996	55.8
1997	47.7
1998	49.7
1999	51.3

Source: OECD Statistics

A number of financial measures are being discussed as part of the preparatory process, including an international tax on aviation fuel (promising ecological benefits), a tax on luxury goods, a tax on the use of global public goods (e.g. international



Funding is also required to promote clean technologies. (gate)

waters, air space, inner space or electromagnetic frequencies). But most interest is now focused on the idea of a tax on currency turnover. This could raise, even on a conservative estimate, more than twice as much revenue as the combined official development assistance budgets of all OECD countries.

Not such a new idea

Way back in 1972, James Tobin (economist, Nobel Prize laureate in 1981) proposed that international currency transactions be taxed in order to stabilise exchange rates and prevent short-term speculation. The basic idea behind what became known as the Tobin Tax is straightforward: every currency exchange is subject to a small tax, to be paid when buying or selling currency. Tobin himself had a 1% tax rate in mind. This would, he said, remove any incentive for short-term currency dealings aimed at profiting from minor exchange rate differentials. It would control the destabilising trend towards short-term speculation.

For a long time Tobin's idea met with little resonance, even among insiders. But in 1995, experts at the UNDP took it up again. Their angle was primarily the potential tax yield and its use for promoting development, rather than its regulatory ef-

fect. Since then, minds have been focused by the financial shocks of the 1990s. Demands for a Tobin-type tax, i.e. a currency transaction tax (CTT), are now widely voiced in relation to the debate on an "international financial architecture".

In this renaissance, Tobin's original proposal has been modified (many regard 1% as too high) and updated. Supporters of a CTT are to be found in parliaments and agencies world-wide. Strong initiatives have emerged from Brazil, Canada and the EU. Even the top international speculator George Soros has noted its advantages as an instrument for stability.

However, the tax is fiercely rejected by many mainstream policy-makers and academics, who say it is harmful, ineffective and unworkable. The often aggressive response of opponents is hardly surprising. Huge vested interests are at stake here: a Tobin Tax would remove billions of dollars worth of profit-taking opportunities for the private investor community.

Short-termism and speculation

With the end of the Bretton Woods system and the liberalisation of the financial sector, global currency transactions have risen 200% since 1970, from \$ 70 million to around \$ 1.5 billion - and we are talking here about daily turnover on the

international exchanges. More than 80% of the \$ 360 billion annual volume is estimated to come from "round trip financial flows", i.e. short-term currency investments for seven days or less. In other words, 80% of dealings are merely hot money, having nothing to do with real economic activity, with trading or productive investment.

Financial flows have become detached from the real economy. A self-referential system has arisen in which exchange rates are no longer determined by the economic fundamentals, i.e. productive investment performance trends, but by the expectations of short-term capital earnings by private players on the financial markets (especially banks, insurance companies and investment trusts). Their transactions cause unpredictable swings in exchange rates, and this turbulence then sets the stage for the currency dealers who can exploit self-generated fluctuations to make more money.

If it were only the speculators who were affected by financial instability and crisis, one might accept currency crashes as an unfortunate symptom of periodic market adjustments. But this is not the case. Although the speculative rush to get out of a currency may be far removed from real developments, the ensuing crisis rebounds heavily on the real economy, damaging the overall development of society. The recent currency crises in Mexico, Southeast Asia and Brazil have slashed real incomes, pushing million of people who know nothing of currency trading into unemployment and social decline. Even developing countries with no significant financial market activity find their path to growth suddenly blocked by the wider financial crisis (World Bank 1999).

How would a Tobin Tax work?

Most speculative currency transactions try to exploit tiny short-term exchange rate movements of just a ten thousandth to a tenth of a percentage point. So even a very small tax on these deals would make them unprofitable. Just how far currency trading would decline will depend mainly on the CTT rate and the expected reaction of market players (elasticity of demand). According to one estimate, a CTT of 0.25% would reduce transaction volumes by up to 33%.

The economics of fixing the optimal rate are complex. Recent proposals range

between 0.05 and 0.5%. A pragmatic approach might be to launch the tax at the low end and gradually raise the rate while observing its impact.

A Tobin Tax makes all currency transactions more expensive, whether they be for productive investment over a ten year period or speculation within the course of a day. However, the clever thing about a CTT is that the additional cost of transactions becomes greater the shorter the period of currency investment. So although genuine commercial business would also be affected, the additional costs are too small to threaten trade in any way.

Short-term speculation and arbitrage would face a completely different situation. The same tiny one-off tax that leaves long-term investments untouched would hit day-to-day currency dealing hard. At tax rate of, say, 0.5%, currency speculators would have to look at week-long investments and annual yields of at least 52% to make any profit.

This simple tax therefore filters out most of the undesirable hot money, while letting through the transactions for trade, long-term investment and real economic processes. It stabilises the financial markets in general and benefits the smaller economies and developing countries in particular. A CTT would be particularly useful for developing countries:

- ◆ by soaking up the excessive liquidity on financial markets, it helps destabilise economies and reduce volatility, without threatening the liquidity needed for commerce and investment;
- ◆ as short-term transactions are reined in, traders lose their incentive to speculate on day-to-day currency movements. This would take the air out of many a speculative bubble that proves so damaging to the vulnerable economies of developing countries;
- ◆ by increasing the cost of short-term transactions, short-term credit becomes more expensive, a CTT would attenuate the risks associated with short-term lending;
- ◆ as a greater stability is established in the world system, development becomes more sustainable. The tax would put predictability back into foreign trade and international lending, leading to more direct foreign investment in the developing world.

No panacea but easy to levy

Most critics argue that a Tobin Tax will not work in stormy conditions. It could not, they say, have prevented the dramatic collapse in Asia. This may be true, but its advocates have never said otherwise. It must be seen as one instrument in a raft of measures (including controls on capital movements, high-risk derivatives and risk capital) designed to regulate international financial markets. Anyway, the CTT concept has been refined to tackle bigger crises: on top of the low basic rate (the Tobin Tax as such) would come a much higher supplementary tax to counter massive speculation in the case of strong exchange rate fluctuations.

Some critics also say the tax is technically not workable. Yet, especially in recent years, financial institutions have, through computerisation, formalised the handling of monetary transactions to such an extent that the logistics of levying a CTT are no harder than the normal debiting of account servicing charges.

A much-needed tax yield

James Tobin was primarily concerned with creating an instrument for stability. But the other key aspect of any tax is obviously its potential yield and what you do with it. This could prove a major bonus for development policy.

As more and more financial players operate beyond the reach of nation states, the tax base for governments is shrinking. Yet the activities of these same global players are creating new costs - economic, social and ecological - that are externalised, and ultimately paid for by ordinary people and the environment. International taxes should therefore be seen as a logical and necessary response to globalisation. For they can give back to policy-makers some of the resources they need to tackle new problems.

The UNDP team has calculated tax yields from various CTT rates. Even a tiny imposition of 0.05% would generate \$ 90.1 billion, which is twice the size of official development assistance from all the industrialised countries! A more substantial 0.25% would yield \$ 302.1 billion.

Who would control the money? International allocation is probably the best solution, with funds going into ecological, social and development programmes designed to achieve sustainable development.

Indeed, the institutions for handling the money already exist within the UN framework. However, resistance to new taxes remains strong in governments around the world, so it may be wise to start with a combination of national and international allocation of the new tax revenues. Countries might be able to use the money for specified national purposes, including poverty alleviation.

Opponents eager to protect profits

Although a Tobin tax makes good sense for the global economic environment and the developing world in particular, it faces stiff opposition from the banking and institutional investor lobby. With the removal of volatility from financial markets, currency dealers could lose billions of dollars. A 33.3% decline in currency transactions would, according to an OECD scenario, cut profits by \$ 60 billion. No wonder that many global players object.

In the present neo-liberal climate, taxes on corporations are declared a barrier to investment - a locational disadvantage. Transnational corporations even boast to shareholders that they have ceased paying any direct taxes to national governments at all. The resulting fiscal squeeze gives governments little scope for action. The present pessimism about direct taxes can be turned around by a Tobin Tax: it does not tax products or work, but the huge surfeit of money sloshing around in the world system. And its application will not disadvantage any one nation state. By levying hot money, it has a redistributive function, from rich to poor and North to South. Indeed, fair taxation may be a key argument in winning over political majorities to this cause.

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