

A Currency Transactions Tax, Why and How¹

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Abstract

The crises and defections that afflicted the European Monetary System in 1992–93 are convincing recent demonstrations that adjustable pegs are not viable. At the same time, experience since 1971 has not fulfilled the more extreme claims of the advocates of floating rates. Transactions taxes are an innocuous way to throw some sand in the wheels of super-efficient financial markets and create room for differences in domestic interest rates, thus enabling national monetary policies to respond to domestic macroeconomic needs.

I proposed a uniform worldwide tax on spot transactions across currencies in 1972 (Tobin, 1974) and in 1978 in my presidential address to the Eastern Economics Association (Tobin, 1978). I have written and spoken on the proposal several times since, but I'm not the type to wage ardent crusades for my crackpot ideas—unlike my great predecessor at Yale, Irving Fisher.

When foreign exchanges seem to be messing up monetary and economic affairs in the ways that then seemed to me to be inevitable, my proposal gets discovered or rediscovered. Recently it has been discovered by a non-economics constituency, those looking for ways to finance the United Nations and other international agencies when the demands upon them are exploding and the member nations are stingy in supporting them.

Flexible or adjustable currency exchange rates plus free movement of funds across currencies are a compound hazardous to the economic health of nations. So say both logic and experience. One way out, of course, is to make exchange rates inflexible and unadjustable—irrevocably fixed, as is true within the United States or Canada or the United Kingdom or other federations, and as may eventually be true within the European Union. However, as the slow and rocky road to Maastricht repeatedly shows, permanent currency unification requires economic, political, and social convergences well beyond those achieved in the decades since the Treaty of Rome. Extensions of currency unification to all of Europe, to the whole Group of Seven, to the emerging industrial economies of Asia, to the whole world, are many decades more distant.

For a long time ahead, we are stuck with national currencies, trying to find the best way to live with them. Yet vast funds are prepared to arbitrage away

differences in national interest rates and to speculate on exchange rates. Here, as in many other dimensions of life on this globe, technologies have outrun economic, political, and social institutions. It is important to make distinct national currencies tolerable, and to make international money and capital markets compatible with modest national autonomy in monetary and macro-economic policy. That is the economic motivation for proposals to throw some "sand in the wheels" of the over-efficient international financial vehicles.

This is, in a sense, a move backward, towards the exchange and capital controls that made past international regimes workable. But it is important not to restore the hodge-podge of nationalistic and bureaucratic controls of those days. Instead, let us seek an internationally agreed, symmetrical, and neutral way to slow down international financial flows, and one with minimal deterrence of trade in goods and services and minimal interference with efficient allocation of real capital among nations.

The traditional controversy between "fixed" and "floating" exchange rate regimes is obsolete. Both regimes are vulnerable to capital movements across currencies. Both involve changeable exchange rates and invite transactions to profit from interest differentials and exchange rate movements. In a floating rate regime, those movements occur in markets, overwhelmingly as a result of private transactions, though sometimes with official currency interventions as well. In a fixed rate regime, changes in the parities which national governments and central banks are committed to maintain involve deliberate official decisions, usually forced by a government's inability to fulfill earlier solemn commitments.

Speculation on currencies occurs in both regimes. Nostalgia for the pre-1971 Bretton Woods system or for a full-fledged gold standard reflects a "grass is greener" syndrome rather than thoughtful analysis. In those fixed-rate regimes, currency parities could be changed and were changed. In their best years these regimes benefitted from circumstances that do not now obtain. First, they were managed by a dominant country with sufficient international financial clout to make its own currency invulnerable, the pre-1914 gold standard by Great Britain, the 1946–1966 Bretton Woods system by the United States. Second, the other national members of the system could and did protect their currencies by exchange regulations and capital controls. Anyway, private funds ready to speculate on currencies were much less formidable threats than they have become now that they greatly exceed central banks' reserves. Third, voters were more tolerant of the economic costs of maintaining over-valued exchange rates. Nowadays governments are held much more responsible for macroeconomic outcomes than before the Second World War or even in the early postwar years.

The crises and defections that afflicted the European Monetary System in 1992–93 are convincing recent demonstrations that adjustable pegs are not viable. Consequently, serious advocates of official parities have been moving towards market flexibility by widening substantially the bands of permissible deviations from parities, and by smoothing-formulas for automatic adjustment

of the central parities themselves towards market experience. Even so, these parameters of the system, the central parities and the limits of the bands, remain vulnerable to speculative attack whenever it appears that the risks of official change in them are predominantly in one direction. Wide bands did not prevent exchange crises in Europe in recent years, or in Mexico in winter 1994–95.

At the same time, experience since 1971 has not fulfilled the more extreme claims of the advocates of floating rates. They thought that exchange rates could be left wholly to private markets, that official neglect of them would be unambiguously benign, indeed optimal. Governments, it turned out, could not be indifferent to currency markets. Volatility in exchange rates and interest rates induced by speculation and capital flows could have real economic consequences devastating for particular sectors and whole economies. For example, the surprise appreciation of the U.S. dollar against the Japanese yen in the early 1980s nearly destroyed the American automotive industry.

Advocates of floating rates had argued that they would free national monetary policies from constraints imposed by commitments to defend official parities. But the same interest arbitrage that limits the autonomy of a central bank in a fixed-exchange-rate regime restricts its powers in a floating-rate regime. If similar financial assets denominated in two different currencies are perfect substitutes in private portfolios, they cannot bear different interest returns in their domestic currencies unless those differences are offset by expected exchange rate movements. Central banks and governments cannot create exchange rate expectations consistent with the domestic interest rates they desire. It is true that exchange market volatility itself should make assets in different currencies imperfect substitutes and create a bit of room for independent monetary policies. But the swings in pervasive market sentiment that generate much of the volatility are not helpful.

Globalization of financial markets has been a much heralded achievement. Innovations in technologies of computation and communications, new markets and institutions, and tides of deregulation have released a flood of domestic and international financial transactions. Vast resources of human intelligence are engaged. Evidently gross foreign exchange transactions alone amount to a trillion dollars daily. Economies of scale are enormous. Transaction costs are small and virtually independent of the amount transacted. Arbitrage or speculative transactions in foreign exchange are so large that minuscule percentages of price spell enormous gains or losses on the capital at stake. The outcomes of financial markets impinge on real economies, local, national, and international, where adjustments are sluggish, transactions are costly, transportation is slow and expensive, substitutions are imperfect and time-consuming, and expectations are fuzzy.

Transactions taxes are one way, a quite innocuous way, to throw some sand in the wheels of super-efficient financial vehicles. A quarter percent tax translates into an annual rate of two percent on a three months' round trip into a foreign money market, more for shorter round trips. It is this effect that creates

room for differences in domestic interest rates, allowing national monetary policies to respond to domestic macroeconomic needs. The same tax would be a smaller deterrent to slower round trips. It would be a negligible consideration in long-term portfolio or direct investments in other economies. It would be too small, relative to ordinary commercial and transportation costs, to have much effect on commodity trade.

J.M. Keynes pointed out in 1936 that a transactions tax could strengthen the weight of long-range fundamentals in stock-market pricing, as against speculators' guesses of the short-range behaviors of other speculators. The same applies to bond markets and to foreign exchange markets. Recently speculators in all these financial markets have focussed on particular items of news, especially on macroeconomic events, statistics, and policies. Keynes's beauty contest applies: speculators concentrate on how "the markets" will respond to news, not on basic economic meanings and portents.

The hope that transactions taxes would diminish excess volatility depends on the likelihood that Keynes's speculators have shorter horizons and holding periods than market participants oriented to long-range fundamentals. If so, it is speculators who are the more deterred by the tax. But it is true that some stabilizing transactions might also be discouraged; fundamentalists alert to long-run opportunities created by speculative vagaries would have to pay the tax too. The judgment that those benign influences are not now dominant in short runs is based on a presumption that the markets would not be so volatile if they were.

In any case, the principal purpose of the proposed tax is to expand the autonomy of national monetary policies. That does not depend on the success of the tax in reducing volatility. The tax would not, of course, permit national macro-economic authorities to ignore the international repercussions of their policies. In particular, the tax could not protect patent misvaluations in exchange parities; speculators' gains from betting on inevitable near-term realignments would far exceed the tax costs. Nor would the tax make macro-economic policy coordination among major governments unnecessary or undesirable. The G-7 ought to concern itself, more than it does now, with the world-wide average level and trend of interest rates, from which individual nations should deviate in accordance up and down with their circumstances.

Vast resources of intelligence and enterprise are wasted in financial speculation, largely in playing zero-sum games. Transactions taxes might reallocate some of these resources. To the extent that they do not, they would at least collect needed public revenues for under-supported international purposes, without the bad side effects of conventional taxes. [I have no estimate of the potential revenues. The yield of a 0.2% tax on a base of a trillion dollars a day is a trillion a year. But I assume that the trillion per day is mostly derivative transactions between dealers, while the tax would apply only to "retail" exchanges.]

In my 1978 article, I advocated channeling the monies collected by the tax to international purposes. I mentioned in particular the World Bank, thinking of

subsidizing loans to poor developing countries. Now, however, there is a growing constituency of advocates of the tax for its revenue-raising potential, not its incentive effects. There is always a tradeoff between these two goals. 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. In this case, however, there's plenty for both. Certainly the needs for resources for international purposes have exploded, as multilateral peacemaking and peacekeeping forces are in great demand, and refugees are suffering all over the world.

A foreign exchange transactions tax would apply to all retail spot, swap, and forward exchanges of currencies. Although collected by the jurisdictions where exchanges are initiated, the tax would have to be internationally uniform, universal enough to render infeasible any important tax-saving relocations of exchange markets. Enforcement would depend principally on the major banks of the world and on the jurisdictions that regulate them. Exchanges between closely related currencies could be exempted on application from the governments involved to the international administrator of the system.

To begin with, an international conference, a mini Bretton Woods, would have to negotiate an agreement establishing the system. The international administrator might logically be the International Monetary Fund. Or a new international financial agency responsible to the member nations might be set up for the purpose, assisted by the IMF and possibly also the Bank for International Settlements. The administrator might be given discretion to set the size of the tax within limits. The administrator would assure the uniformity of the tax among jurisdictions and would handle the transfers of the agreed shares of revenues to the designated international institutions. Exemptions from the tax for linked currencies would have to be adjudicated. The rate of tax might need to be changed from time to time. The IMF, bereft of its original central functions by the demise of the Bretton Woods monetary system and superseded by regional regimes in Europe, should welcome these new responsibilities.

Critics of the "Tobin tax" are sure that transactions would be moved from financial centers to "off-shore" tax-free locations. I suspect that this danger is exaggerated. There are considerable costs, both fixed and operating, involved in such relocations. Otherwise low wages and rent would already have offered opportunities for saving brokerage costs and existing taxes and attracted many more financial activities, markets, and institutions than they have.

Nevertheless, it is certainly desirable to assure that all jurisdictions cooperate. Therefore, I propose that collection of the tax be required of every member of the IMF, as a condition of eligibility for credit from the Fund. As a result, "outlaws" not cooperating with the international tax would probably have difficulties getting credit or assistance anywhere.

Most, but not all, of the aggregate revenues collected by the national jurisdictions would be dedicated to international purposes and turned over to international institutions. But the formula for splitting revenues would be progressive. Poor and small countries would keep for themselves most or all of

the revenues they collect. The purpose of requiring their adherence is to prevent them from undermining the system by not participating, not to collect major revenues when they do participate. The big financial powers would be the big sources of revenue for international purposes.

Other criticisms of the currency transactions tax are variations on the theme that markets generate optimal results, so that this interference in them is bound to be bad. There's no arguing with true believers in the faith. Given the myriad other hurdles to real commercial and capital transactions in the world, it's hard to see how this modest tax can result in noticeable distortions. Indeed if it yields exchange rates that better reflect long-run fundamentals, it will enhance welfare.

Some critics do not sympathize with my objective of preserving a modicum of autonomy for national monetary policies. They regard any discipline that currency arbitrage and speculation imposes on any country as justified. Let all countries avoid demand-management policies, both monetary and fiscal, and we will all converge to our natural rates of unemployment. I think the experience of Europe over the last fifteen years refutes that Panglossian view. The theory on which it is based is mostly a product of American economists, but fortunately neither our government nor (at least to date) our central bank has taken it as seriously as European policy-makers. I cannot expect those who diverge so basically from my macroeconomic premises to see any good in my proposal.

Finally, of course, I cannot expect bankers and others who would pay the tax, or suffer any reduction it might cause in the transactions from which they profit, to approve. They, of course, have considerable influence on central bankers and on international monetary and financial officials.

Postscript

I realize that here, as is often the case, I am seriously opposed by a powerful tide. A widespread orthodoxy is that financial markets know best, that the discipline they exert on central banks and governments is salubrious. When capital movements are adverse, that 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 painful and cruel punishments for crimes of fiscal and monetary policy it did not commit, should suffice to raise doubts about the "markets-always-know-best" proposition.

Recently doubts have spread regarding the desirability of completely unfettered mobility of financial capital across currencies. Throughout the Bretton Woods era and a decade afterwards, official restrictions were common, even among advanced industrial countries with sophisticated domestic financial institutions and markets. In retrospect those years look pretty good, compared with the volatilities and crises of the last ten years.

I notice that the informal commission of wise men chaired by Paul Volcker recently expressed anxiety about world monetary turmoil. At the annual meet-

ings 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 possibly useful measure if enforcement problems could be solved. (IMF Survey January 22, 1996) Stanley Fischer, First Deputy Managing Director of the IMF and thus the Fund's chief economist, agreed.

Fischer 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 of all members complete convertibility of their 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 sand in the wheels of some kind 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.

Notes

1. This paper is a revised version of a paper presented at the Conference "Globalization of Markets" organized by CIDEI (Centro Interdipartimentale di Economia Internazionale, Universita' di Roma La Sapienza) in Rome, 27-28 October 1994 and distributed as CIDEI Working Paper No. 29. The paper uses in part materials in Eichengreen, Tobin, and Wyplosz (1995).

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