

Chapter 2: Instrumentation

What concept to choose for a tax on foreign exchange transactions?

Before posing the question of the feasibility of a tax on foreign exchange transactions it is necessary to clarify how the concept of the tax to be realized should look like. The Tobin tax as originally conceived is not the only option of a tax on foreign exchange transactions. Alternative proposals have been developed starting from points where the Tobin tax exhibits clear conceptual weaknesses.

It is therefore necessary to clarify the question of the concept and its instrumentalization before posing the question of its operationalization and implementation. The purpose of this Chapter is to develop a basically functioning and politically feasible concept of a tax on foreign exchange transactions. This requires to first reduce the complexity that goes with the original proposal by Tobin.

► **Reduction of complexity.**

The alleged non-feasibility of the Tobin tax is often explicated by a number of economic, legal, administrative and political complexities.

¹ For an analysis of these weaknesses see in particular Spahn (1995), Shome and Stotsky (1996), Nadal-De Simone (1997), or (in German) Buch, Heinrich and Pierdzioch (2001).

- Under economic aspects, it is criticized that the Tobin tax would

- produce similar inefficiencies as the multi-phase tax on gross transactions of commodities that applied in the Federal Republic of Germany before 1968. It was censured to entail a cascading effect, which led to a varying tax burden on final products in accordance with the number of transactions. This must provoke organizational reactions (such as the vertical integration of processes), which undoubtedly distorts economic decision making;

- produce particularly heavy distortions of this kind as long as it is impossible to introduce the tax universally, since this would dislocate parts of foreign exchange markets to non-cooperating tax havens. Moreover the tax could be avoided by moving into trading with other instruments such as short-term foreign securities (treasury bills etc.) or through forward and derivative trading.

- put a one-sided burden onto the competitiveness of the respective financial centers and squeeze worldwide liquidity trading, which would trigger unsolicited systemic changes.

- Under legal aspects it is often asserted (without further examination) that the tax would disagree with the idea of capital liberalization in accordance with the *Liberalization of Capital Movements Code* of the OECD or, in the case of the EU, the Maastricht Treaty.

- Under administrative aspects it is reckoned that the international community of important financial centers is unlikely to cede sovereignty in the area of taxation and consent to the creation of a world tax organization, which would be reasonable for operating a universal and multilateral tax on foreign exchange transactions. It is

equally to expect that there is corresponding interjurisdictional cooperation in this matter. Most of the governments of OECD countries (in particular the United States) reject the idea of a Tobin tax at present.

- Under political aspects it is a totally open question who would be entitled to collect the tax revenue. Tobin himself thought of international organization (IMF, Worldbank, United Nations). But there could also be supranational organizations to be newly created, international public foundations and non-government organizations (NGO). In principle it would also be possible to distribute the tax revenue onto national tax authorities, however the distribution formula is likely to be highly controversial.

Even if those questions would have been resolved it is still open for which purpose such revenue should be used, who would be the recipient, who would administer it, and how a legitimate democratic and administrative mechanism for controlling such institutions should look like.² If one thinks in particular of a transfer of resources toward developing countries, it is open in which way these countries could participate in the decision process.³

As to legal questions, these do not fall into the terms of reference of this study. It has to be emphasized however that the freedom of capital movements is not abolished or put in

² Patomäki (2001) argues that a global tax on foreign exchange transactions would also strengthen national sovereignties, and he conceptualizes an institutional framework for its administration that aims at the democratization of the process of globalization.

³ This question is unsatisfactory even now as to the development of international financial markets. See for instance Griffith-Jones (2001).

jeopardy just because a tax is levied on such transactions. Taxes are levied on various transactions of goods and services and are typically regarded by economists as conforming with the market. In most respects they are superior and to be preferred to other types of government intervention such as capital controls, or monetary policy involvement of the orthodox type. The key question under legal aspects is whether taxes are neutral with regard to the competitiveness of different actors in the market.

In the following I shall assume that legal problems would not emerge within the framework of the European Union as long as certain preconditions are fulfilled. This point of view is supported by a study for the Parliamentary Working Group "Tobin tax" of the European Parliament.⁴

This study asks in particular for a small rate of the tax on foreign exchange transactions, which „à la lumière de ses objectifs, n'entrave pas les mouvements de paiements de manière déraisonnable ou disproportionnée.“ This must have repercussions on the fiscal objectives of the tax. They will be addressed later on.

► **Limitations.** In view of a multiplicity of unresolved political questions that relate to the universal and multilateral character of the Tobin tax, this report will confine itself to *limited scenarios*. In order to be realistic these scenarios will have to acknowledge the following:

- The tax on foreign exchange transactions cannot be introduced universally. It is required that the tax be planned by an existing authority, a government or a coordinating body such as the European Council, and be introduced by le-

⁴ The study has been prepared by Lieven A. Denys, professor for European tax law at the *Faculté de Droit* of the Vrije Universiteit Brussels. It dates of April 18, 2001.

gitimate parliamentary institutions. The tax would therefore work *unilaterally* and *partially*, not multilaterally and universally.

- The same legislature that is accountable for the tax will also decide on the apportionment and use of the tax proceeds. It implies the revenue to fall to a national government (respectively jointly to all governments that engage in a coordinated effort), but under no circumstances would it go to international organizations.⁵ A tax on foreign exchange transactions to be introduced unilaterally by the European Union would be subject to decisions of the European Council and the European Parliament as well as national parliaments that would have to ratify the law.

All proposals that go beyond such limitations must be considered unrealistic, and be excluded as politically "unfeasible" for the time being.

In the following I shall call this limited decision space "politically feasible". In order to account for eventual legal scruples, I shall also posit a much lower tax rate than was considered by Tobin and his supporters.⁶

While I have been using the terms „tax on foreign exchange transactions" and "Tobin tax" synonymously so far, I shall speak of a „politically feasible Tobin tax (PFTT)" from now on, which shuns the critical objections against a multilateral and universal tax.

Before entering into examining economic and technical aspects that are important for the realization of a PFTT, I shall first discuss a few variants of taxes on foreign exchange

⁵ This could eventually be achieved in a second round via the explicit earmarking of tax proceeds or through budgetary decisions of (the) parliament(s).

⁶ See also Clunies-Ross (2000).

transactions that are politically feasible and are relevant in the context of a PFTT.

► **Relevant variants of taxes on foreign exchange transactions.** The following concepts are related to taxes on foreign exchange transactions:⁷

1. “Non-remunerated reserve requirements (NRR)” on short-term foreign exchange deposits.
2. The taxation of cross-border capital transactions with a „cross-border capital tax (CBCT)“.
3. A two-tiers „Tobin-cum-Circuit-Breaker Tax (TCCBT)“. It consists of a PFTT as a base and an „exchange-rate normalization duty (ERND)“ that responds to exchange rate volatility.

► **„Non-remunerated reserve requirements“ (NRR)**—NRR have been used in various forms as unilateral policy instruments, even in the Federal Republic of Germany (introduction of a „*Bardepot*“ for foreign deposits in 1971). Spain has employed the instrument in 1992 during the peseta crisis. The best-studied case appears to be the one of Chile during the 1990s⁸, but also Colombia⁹ and Slovenia have used the instrument. Since a part of the inflow of currencies has to be kept in the form of mandatory non-interest bearing deposits, lost opportunity costs act like a tax. This is why the measure is often discussed in the context of a

⁷ For further variants, that are interesting basically under theoretical aspects, see Spahn (1995, Appendix 2).

⁸ See for instance Nadal-De Simone and Sorsa (1999). The reserve rate in Chile was at first 20 percent, then 20 percent, but it has been reduced intermittently to 0 percent, whereby the system has however been maintained in principle.

⁹ The experiences with capital controls in Latin America have been discussed, inter alia, in Agosin and Ffrench-Davis (1996).

PFTT.

Chile has used NNR to fend off short-term capital inflows and to avoid artificial short-term appreciations of its currency. At the same time the device was expected to secure solvability in the case of a reversal of foreign capital flows, and to deal with the pressure of depreciation.

It is debatable whether this strategy was successful, because nobody is in a position to say whether speculative capital inflows have been successfully suppressed by the measure. The mere indication that capital inflows have endured and the Chilean peso has appreciated in spite of the measure is not sufficient for prove. The fundamental data of the Chilean economy were extraordinarily positive during that period, and the country was therefore highly attractive for non-speculative foreign capital regardless of the NNR. Under fiscal aspects the Chilean NNR were quite successful however, and this in spite of the fact that market participants were developing successful strategies to evade the loss of interest payments. This had repeatedly forced the central bank to adopt new measures in order to close loopholes of the system.

This is not the place to discuss the experiences with NNR further. It is however conceptually helpful to stress the following points with regard to a PFTT:

- NNR concern primarily the holding of stocks, not transactions (flows), whereby stock will of course vary in response to transactions. The comparison with a tax on foreign exchange transactions is therefore strictly not fitting.
- Compared to the volume of foreign exchange transactions, the parts of the capital balance that are subject to the tax are significantly smaller. This finds its reflection in a much higher “tax rate” compared to feasible rates of a PFTT. Assuming that the rate of interest for

foreign capital is 10 percent p.a. and the required NRR 30 percent, this would give a “tax” burden of 3 percent, a significantly higher rate than the rates discussed in the context of a PFTT.

- ▶ More important is the fact that the „tax burden“ (contrary to the Tobin tax) is directly (and *not inversely*) proportional to the holding period of the asset. For instance a short-term investment for one week would carry a charge of 3/52 percent, while the charge would be 3 percent for an investment over a year. This proportionality of the charge runs counter Tobin’s conceptual idea. This is why NNR are accompanied (also in Chile) with a host of exceptions aimed at exonerating exporters and importers as well as long-term investors. These exceptions engender substantial administrative costs, they generate “loopholes”, and they are still incapable of eliminating the systemic bias of tax-burden proportionality for short-term investors. The speculator with an extremely short-term commitment is affected the least, while other investors would bear the brunt of the charge.

▶ **The „cross-border capital tax“ (CBCT)**—The proposal of Zee (2000) to tax cross-border capital flows with a CBCT has not yet been tried—contrary to the NNR. However it fulfills the requisites of “political feasibility” and is therefore an interesting alternative. The objective of the tax is—similarly to the NNR—to fend off capital imports that could become an exchange rate risks because of their short-term nature. The CBCT avoids the systemic bias of the NNR. It is therefore a proper transactions tax.

The proposal consists of two parts:

1. At first all private capital inflows into the country a fraught with a withholding tax. Assuming again

an interest rate of 10 percent p.a., a tax rate of one percent would be equal to 10 percent of the income from an investment of one year, but put a confiscatory 125 percent charge on income from an investment of one month.¹⁰ This renders the approach similar to the Tobin tax.

2. Moreover Zee wants the CBCT withholding tax to be credited against transactions that are not related to capital imports. Exporters receive the tax credit through the value-added tax¹¹; this is a simple administrative procedure. Recipients of interest payments, dividends, repatriated profits etc. would receive a reimbursement when filing for the income tax; this is of course more complicated in administrative terms than in the case of VAT credits for exporters.

I shall refrain from a more comprehensive analysis of the proposed instrument. In comparison to a PFTT however, the following points seem be worth emphasizing:

- ▶ Transnational capital movements are not necessarily identical with foreign exchange transactions. They could also be settled exclusively in foreign currencies (e.g. the US dollar).¹² This renders the CBCT similar to NNR. It is not the transaction as such that is subject to the tax, but ultimately only the (positive) variations of the net capital balance, adjusted for certain positions of the current balance.

¹⁰ See Appendix 2 for the calculation (formula (4)).

¹¹ The tax rate for exports would thus be –1 percent rather than 0 percent under VAT that applies the destination principle.

¹² Within the EMU there are even transnational capital movements that are carried out in “domestic currency” (the euro). In developing and emerging economies it is not unusual to employ the US dollar as a mean of transaction.

- ▶ The CBCT covers only capital imports, not capital exports. It works thus asymmetrically. The objective is to limit capital inflows, not to establish a “mouse trap” for foreign investors. By emphasizing the destabilizing effects of *capital imports* (and by refraining from checking capital flight altogether), Zee takes up an important aspect that also motivated my earlier proposal of 1995 (see below).¹³
- ▶ The settlement of payments (and payments backed by borrowing) can be effected entirely outside a currency area. They may appear as changes of assets and liabilities in the books of accounts of economic agents, but never trigger any cross-border transactions.¹⁴
- ▶ Movements of the capital balance are significantly smaller in volume than the transactions (payments) that are targeted by the PFTT. This is explained partially by the fact that there may be many (liquidity) transactions behind net capital movements. A CBCT will only target the result in economic terms. It is also explained by the asymmetrical construction of the tax (there are no charges on capital exports as a result of imports of goods and services, or of income transfers abroad). And finally it hinges on the various exemptions entitling economic agents to a tax credit under the CBCT.

In particular the tax credits render the scheme extremely complex. For instance foreign investors would not

¹³ My own proposal also aims at checking very short-term capital inflows through the normalization duty, while longer-term investments go untaxed with almost 100 percent probability. Contrary to Zee’s proposal however, my own approach is symmetrical in that it covers both capital imports and exports.

¹⁴ Such books of account can of course be kept „unofficially“ if this allows avoiding the tax (in particular in emerging and developing countries).

have to pay a tax when repatriating their profits, but the initial import of capital may have been subject to the tax. But the foreigner had of course no possibility to credit the tax against his or her income tax.¹⁵

Summarizing it can be said that the proposal of a CBCT has a number of advantages compared to NRR, in particular because it respects the inverse relationship between the holding period and the tax burden. In administrative terms the CBCT is however likely to exhibit similar complexities as the NRR, perhaps even more as regards the integration of the tax with the personal income tax.

▶ **The Tobin-cum-Circuit-Breaker Tax (TCCBT).** My own proposal (Spahn 1995, 1996) can be understood to solve the basic conflict between the two objectives of a PFTT:

✓ *Either the tax rate is too high:* This may fend off speculators, but it exhibits significant negative consequences for the allocation of resources by reducing (and even possibly eliminating) international liquidity trading. It is doubtful whether the tax would achieve the goal of exchange rate stability under these circumstances, because hedging operations would become more costly and pricing information is taken out of the market.

✓ *Or the tax rate is very low:* In this case international liquidity trading could continue to operate fairly unimpeded, but the tax is unlikely to deter speculation.

¹⁵ This statement is correct only in principle, but is more complicated in practice. Undoubtedly a tax on capital imports will not be creditable against foreign income tax according to double-taxation treaties. But one may expect the financial industry to develop products whereby the capital import tax is initially swapped onto a domestic agent (who credits the tax against income tax), and re-swapped thereafter. Foreigners are thus exonerated via the pricing of such swap instruments.

There are also fiscal objectives associated with my proposal. The idea is to avoid a contraction of the tax base following the introduction of a TCCBT, and to bolster the revenue potential of the tax in periods of speculation.

The TCCBT consists of two integrated parts that relate to the same tax basis, namely „relevant foreign exchange operations (RFXO)“, which I shall have to specify more precisely later on.

1. The first tier is a classical Tobin tax (PFTT), however with a tiny rate. This tax rate is uniform for each currency pair, but it could eventually vary for different markets in accordance with the size of the bid-ask spread.¹⁶ It is decisive that the tax rate be comparably neutral on liquidity trading. This tier of the TCCBT has mainly fiscal functions, but it can also contribute to stabilizing exchange rates to the extent that it eliminated destabilizing noise trading.¹⁷
2. The other tier consists of an additional charge that is specifically tailored to discourage speculation. Under normal circumstances this tax is dormant, but it is triggered automatically whenever there is speculation on foreign exchange markets.¹⁸ Thereby speculation is valued to represent a negative externality (such as a “pollution” of

¹⁶ I shall come back to the question of the tax rate, but I shall finally accept a uniform tax rate in spite of varying spreads for different currency pairs.

¹⁷ See Chapter 1 and in particular the contribution by Summers and Summers (1989).

¹⁸ This process is controlled through an algorithm within the settlement system for foreign exchange, i.e. the formula pre-exists in the form of a computer program and is recognized by all market participants *a priori*. So the pricing conditions are always *known in advance*. An advantage of the tax is the fact that there is no need for discretionary decisions—neither on the side of legislators, nor on the side of the actors in foreign exchange markets.

foreign exchange markets), and this externality is charged with a tax of the Pigou-type. The aim is to reduce the externality—similar to approaches of environmental policy. The tax rate of the additional charge on the negative externality may be very high. The additional charge has only a regulatory function and no fiscal objective. On the contrary: If it achieves its goal and holds back speculation, the charge *cannot* yield any revenue.

The additional charge, which I have dubbed „exchange-rate normalization duty (ERND)“ on another occasion (Spahn 1996), deserves some further reflections on its specific features:

► Which is the tax base of the ERND? “Negative externality” has to

be rendered operational for taxation, and to be standardized for legal purposes. To this effect I was inspired by the EMS (European Monetary System) that was operational in the EU from 1979 until the introduction of the euro. In order to guide monetary policies, it worked with a

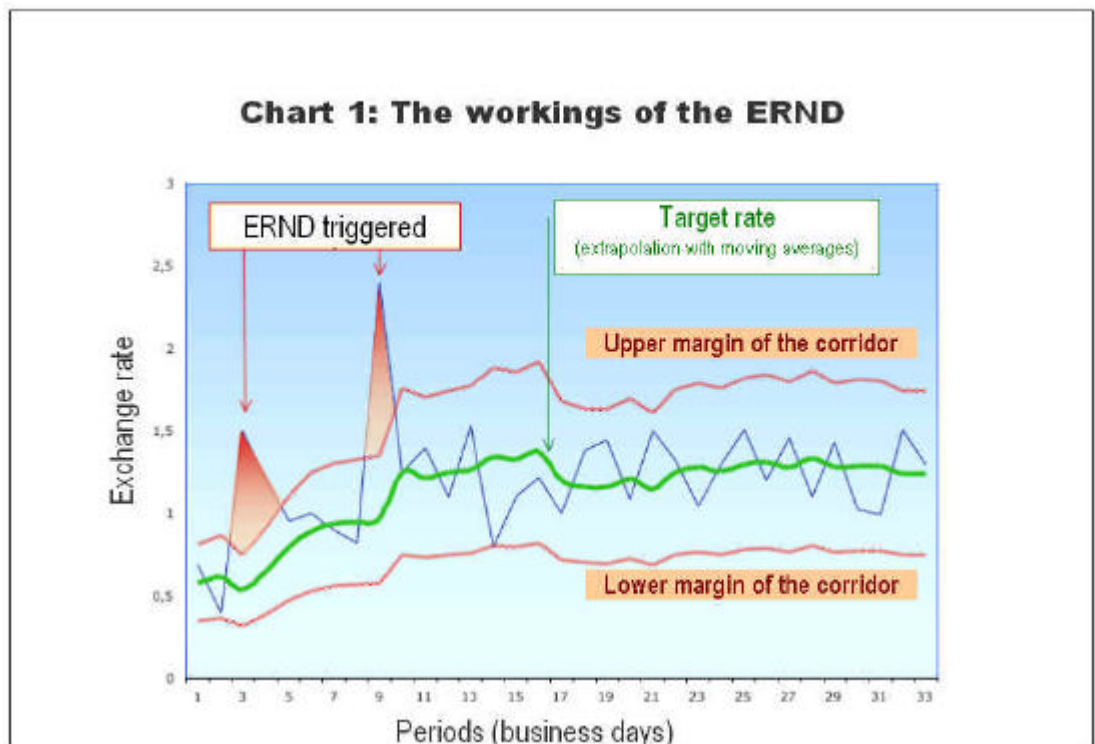
1. target rate, the ECU reference rate,¹⁹ and
2. a target zone (or „corridor“).²⁰

Once the exchange rate would deviate from the target zone, the central banks of the respective countries were compelled to bring the rate back into the corridor by means of monetary policies.²¹

¹⁹ This rate corresponded to a weighted arithmetical average of 12 European currencies.

²⁰ This corridor was defined relative to the target rate, and was initially 2.25 percent (for some currencies 6 percent), and later 15 percent.

²¹ The system is sketched in a simplistic way here. In fact there was an obligation for infomarginal interventions whenever the exchange rate would tend towards an intervention point, although it was still in the corridor. Moreover



I chose a similar approach to defining negative externalities that result from speculation on foreign exchange markets. It requires standardizing “speculation” in a technical sense.

Speculation usually finds its expression in an abrupt change of the exchange rate (see the examples in Appendix 3). If there is a well-defined official target for the exchange rate and an equally well-defined corridor, it is possible to distinguish “normal transactions” as those that are carried out within the price corridor. These transactions are considered non-speculative and are exempt from the surcharge. However if there are deviations from the corridor, this is considered to represent a negative externality (i.e. “pollution”) and will be charged with a Pigou tax.²²

the instruments of monetary policy and their coordination were regulated in a more detailed fashion.

²² This procedure could be considered to represent the „dual solution“ of the EMS that operated with monetary instruments. Instead of reacting to speculation by means of a subsidy (for instance high interest rates for overnight deposits), the dual scheme would use a tax policy instrument. Instead of using foreign

Different from the EMS, the target rate of the ERND is an adjustable moving average of daily official exchange rates relative to a reference or anchor currency (such as the US dollar or the euro). The workings of the ERND are sketched in Chart 1.

► **How to define the corridor, the anchor currency and the tax rate?**

The EMS had defined the upper and lower boundaries of the corridor in an *ad hoc* fashion, i.e. pragmatically. The same should apply to the ERND. However the width of the corridor could be determined with regard to empirical data on the daily fluctuations of the exchange rate relative to the target rate under normal circumstances, perhaps with some safety margin in order to trigger the duty not too often. These daily fluctuations could vary for different pairs of cur-

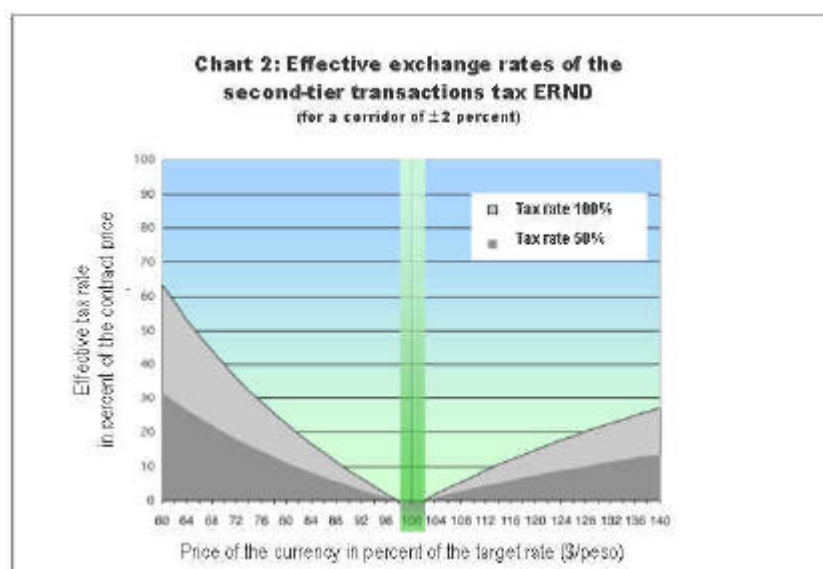
exchange reserves to support the exchange rate, the country under speculative attack would achieve revenues with the dual scheme. We know from environmental policies that taxes and subsidies can be equivalent instruments to cope with correcting externalities and a misallocation of resources.

rencies, which could lead to the conclusion to use different bandwidths for different currency pairs. Since the scheme operates unilaterally, this can be determined individually by each country. The same is true for the respective anchor currency (respectively currency basket) and the tax rate to be chosen.

The statutory tax rates of the ERND should be high, within a range of 50 to 100 percent.

► Isn't a tax rate of 100 percent confiscatory?

It is important to realize that the tax rate is *not applied* to the value of the transaction as such (as for the PFTT), but only on the externality, i.e. that part of the price that lies outside the corridor. It means that the effective tax burden is variable—with a burden of 0 percent within the corridor and at its margin, and an effective tax burden that increases with the degree of deviation from the target zone. The effective tax burden for statutory ERND rates of 50 and 100 percent are depicted in Chart 2.



The variable effective burden on a transaction that is carried out at prices outside the corridor also conforms to the conditions for a neutral (respectively allocation-enhancing) Tobin tax (Tornell 1988, 1990).

► Must the ERND not fend off potential capital investors?

The contention that the ERND would deter potential investors—in particular because of its high statutory rates—seems to be totally unwarranted.

- ✓ On the one hand the effective tax burden is significantly lower than the statutory rates (see previous paragraph), although it could indeed increase with the degree of deviation from the target zone.
- ✓ On the other hand will the ERND be activated only in those instances when the exchange rate wreaks havoc. This is an eventuality whose probability is extremely low and uncertain as to its timing. In relation to a future trading hour, the probability of an activated ERND is practically (and mathematically) zero.

If there are investors to fear the ERND, they are exclusively those with a short time horizon who are betting on speculative rents. It is exactly this group of investors that schemes such as NRR and the CBCT aim at deterring from investing in a country. The

ERND appears to be much more effective in this respect as well as more targeted, because it will be activated immediately and automatically (via a previously installed software). It thus works in the form of an automatic “circuit breaker” against foreign exchange speculation.

Long-term investors are likely to disregard the tax altogether however, because its activation is improbable over a longer period of time.

On the contrary: One may even expect long-term investors to be encouraged to invest in a country that employs an ERND. This is because the surcharge acts as a sort of insurance. It guarantees practically that the exchange rate will never vary more than the set bandwidth in one day. In comparison to the potential alternative without the tax (a possible “free fall” of the rate) this must be considered a considerable advantage. The same is true for importers and exporters. They should be prepared to pay even a premium for this exchange-rate guarantee either in the form of (an occasional) ERND, or in the form of a currency option.²³

► Wouldn't the ERND lead to deviations from the equilibrium exchange rate?

Given the design of the ERND, variations of the target rate are perfectly possible. For instance, if the period for the moving average consists of 20 business days, it is possible to incorporate in the exchange rate all fundamental data that become available over a month. Therefore the ERND does not permit a “leaning against the wind” policy because it allows the adjustment of the exchange rate to fundamentals in a continuous fashion. Appreciations and depreciations of the currency are possible and accepted. It is only in the case of abrupt exchange rate changes—typical for periods of speculation—that the ERND works as a circuit-breaker.

This defuses equally the argument that governments could hide behind the scheme to carry out irresponsible policies at the expense of investors.

²³ It can be expected that the financial industry will assume the ERND risk for exporters and importers, who are often more dependent on short-term payment requirements than long-term investors, in the form of currency options net of tax. In this way the implicit insurance premium would become an explicit cost of the insurance scheme.

► Which countries could benefit from an ERND and what is its relationship with the orthodoxy?

The concept of an ERND is primarily suitable for transition, emerging and developing economies that aim at accessing free international capital markets. For industrialized countries the concept is only apposite for those that do not belong to one of the larger currency areas (US dollar, euro), but seek to peg their money to an anchor currency. The ERND does not appear to be reasonable for the USA or Euro-land. Exchange rate volatility between the dollar and the euro could perfectly be controlled through the coordination between the ECB and the Fed.

The advantage of the ERND as a *unilateral* measure consist in particular in that national Legislatures can determine the conditions for their own scheme at their discretion, without having to coordinate with other authorities. The period for the moving average, the calculation of the target rate, the width of the corridor, and the tax rate could all vary from currency to currency.

Whatever the advantages or disadvantages of an ERND, it is always appropriate to evaluate it against the benchmark of current alternatives—in particular against the practices of the orthodoxy. Orthodox politicians prefer monetary interventions by central banks rather than tax policies.²⁴ This calls for the following annotations (Spahn 2001):

1. Tax policy is an instrument conforming to the market. This is true for monetary policy only if it is long-term oriented, but not for the short run when it may be compelled to hectic reactions under speculative pressure. An advantage of the tax policy approach is notably that the rules have to be

²⁴ There are of course also „harder“ interventions such as capital controls, which I shall not use as a benchmark for that matter.

established *a priori*. They are known to all participants and are therefore predictable. This does not apply to an extemporizing monetary policy.

2. The unpredictability of monetary policy in times of speculation has a number of severe drawbacks that even *encourage* speculation:

- ✓ At first will hectic interventions signal *policy distress* to market participants. Tax policy is a procedurally neutral measure that acts automatically as a built-in stabilizer.

- ✓ Then will monetary intervention encourage speculative behavior if market participants can reasonably expect the central bank to be politically compelled to bail out. The ERND will procure the necessary room for monetary abstinence by the central bank and allow it to focus mainly on domestic policy objectives.²⁵

- ✓ Moreover it is not negligible that the ERND will produce revenue during periods of exchange rate turbulences, whereas monetary policy intervention is tantamount to subsidizing foreign exchange trade—as mentioned before. This is true for its interest rate policy, which aims at rendering domestic assets more attractive, and for its direct interventions in foreign exchange markets, whereby valuable reserves are sacrificed just to stabilize the exchange rate. Monetary policy interventions—preferred by the orthodoxy—also entail a negative impact onto the real economy of countries under speculative pres-

²⁵ This was one of the most important goals of Tobin with his tax on foreign exchange transactions. Monetary policy abstinence during periods of an activated ERND is even mandatory for its effectiveness, because traders would otherwise attempt to shift the burden of the tax onto the central bank.

sure.²⁶

- ✓ Finally, the greater independence of the central bank from exchange rate turbulences will also render the country less dependent from foreign capital investors and the support by international organizations such as the IMF. If there is need to intervene in currency markets beyond the loss of currency reserves, it tends to increase the foreign indebtedness of the country, which renders its currency all the more vulnerable to speculation because the confidence in the economy is dwindling. Moreover the country is burdened with debt service, and—if devaluation is ultimately unavoidable—it loses additional net wealth because its foreign indebtedness, measured in domestic currency, will increase in proportion to the rate of devaluation.

Given these considerations and against the background of reoccurring currency crises, which are tackled in vain with orthodox instruments over and over again, it is incomprehensible why tax policy interventions in foreign exchange markets should have such a bad reputation.

The TCCBT possesses significant allocative and distributive advantages compared to orthodox instruments as long as negative repercussions on international liquidity trading can be avoided. How this could be achieved will be discussed in the following Chapter.

²⁶ This is true in particular for interest-rate policies "... as with simply raising interest rates to defend a weak currency, it is virtually impossible to burn the speculators without simultaneously affecting other sectors of the economy" (Garber and Taylor (1995), p. 178). As has been argued previously, monetary policy interventions may also lead to a transfer of net wealth at the expense of the countries concerned.

► **Summary.** This Chapter has discussed the basic conditions for a politically feasible tax on foreign exchange transactions, and developed an effective set of instruments.

The scope for decisions is politically constrained in that the tax has to be introduced and be accounted for by existing decision-making bodies such as national and supranational parliaments. The tax works therefore *unilaterally* and *partially*, not multilaterally and universally. Moreover the tax yield will fall to whoever will be responsible for legislating the tax, not to international institutions. They could get hold of the tax revenue only in a second step—via budgetary transfers.

Among the measures that are “politically feasible” in this sense range the going practice of mandatory non-interest bearing deposits on foreign exchange transactions (respectively foreign exchange positions) and a proposal by Zee, who would levy an asymmetrical tax on capital imports. Both instruments are interesting as parts of an arsenal aimed at combating currency speculation. In particular mandatory deposits are likely to constitute an important element within a future global financial architecture. The proposal of a tax on capital imports appears to be laden with com-

plex administrative problems however, which will render its realization less likely. Both instruments are however significantly different from a tax on foreign exchange transactions and will no longer be examined in the remainder of the report.

“Politically feasible” appears to be a combination of a unilaterally acting Tobin tax with a low rate as a “true” tax on foreign exchange transactions, in combination with a surcharge that reacts on speculative variations of the exchange rate. Both are technically intertwined.

The proper Tobin tax could be used by groups of OECD countries, for instance by the EU. The surcharge should be used unilaterally only by transition, emerging, and developing countries as well as those industrialized countries that remain outside the major currency areas, but aim at pegging their currencies to an anchor currency (or a basket of currencies).

The combination of two taxes in the form of a Tobin-cum-circuit-breaker tax has significant allocative and distributive advantages over an exchange rate policy that is based on orthodox monetary policy.