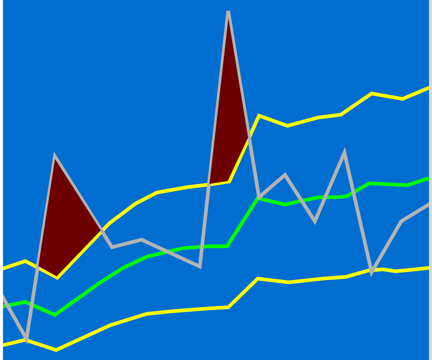

On the Feasibility of a Tax on Foreign Exchange Transactions

REPORT

To the Federal Ministry
for Economic Cooperation
and Development, Bonn

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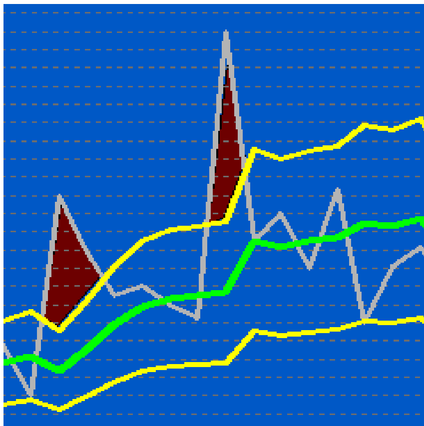

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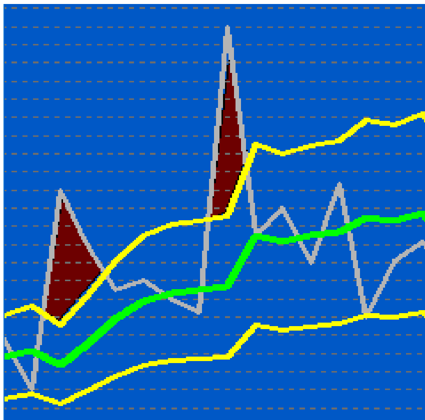

On the feasibility of a tax on foreign exchange transactions

Summary

A tax on foreign exchange transactions is expected to realize different objectives:

1. The stabilization of exchange rates,
2. the exploitation of new revenue sources
3. the redistribution of resources, in particular between financial and producing sectors, and between nations (in particular between the North and the South) , and
4. aspects directed toward transforming the world economic order, in particular with the aim of controlling the process of globalization.

Systemic change is not pursued in this report. On the contrary: The proposals of a tax on foreign exchange transactions are contingent on avoiding a negative systemic impact. Aspects relating to distributional issues are discussed in an ancillary manner only. They fall ultimately in the realm of politics.

The present study focuses mainly on the feasibility of a tax on foreign exchange transactions with emphasis on the objectives of exchange-rate stabilization and fiscal revenue.

The scope for political decisions on a tax on foreign exchange transactions is constrained by the fact that the tax has to be introduced and accounted for by existing political decision bodies, in particular national and supranational parliaments. The tax will therefore have to be unilateral and partial, not multilateral and universal. Moreover, tax revenue will fall to the jurisdiction that is accountable for legislating the tax, not to international organizations. Multilateral international bodies may however be given some or all of the revenue in a second step—via budgetary grants.

The analysis has brought to the fore the following results:

Political restrictions

1. As to „politically feasible" instruments to curb foreign exchange speculation, the discussion focuses on non-remunerated reserve requirements of foreign currency transactions and/or deposits. There is also a proposal by Zee to use an asymmetrical cross-border capital tax on imports of foreign capital (albeit not on exports). Both instruments are interesting as parts of an arsenal devoted to coping with currency speculation.

2. In particular non-remunerated reserve requirements are likely to form part of the future global financial architecture.

3. The proposal of an asymmetrical tax on cross-border capital flows appears to be laden with severe and complex administrative problems however. This renders its realization highly unlikely.

4. Both instruments are essentially distinct from a tax on foreign exchange transactions as examined in this report.

Concepts

5. To reconcile the objectives of exchange-rate stabilization and revenue generation, a unilateral and „politically feasible" Tobin tax (PFTT) on foreign exchange transactions with a small rate, combined with a high-rate surcharge on externalities resulting from speculation, the „Exchange Rate Normalization Duty" appears to be most promising. Both taxes would be technically intertwined.

6. The Tobin tax proper can be implemented unilaterally by member states of the OECD, individually or (preferably) as a group. It could also be implemented by the European Union in cooperation with Switzerland.

7 The exchange-rate normalization duty should be applied unilaterally, but only by transition, developing and emerging economies, and by those industrialized countries that aim at pegging their currency to one of the larger currency areas (or a basket of currencies).

8. The combination of two taxes in the form of a *Tobin-cum-Circuit-Breaker* Tax possesses significant allocative and distributive advantages over the prevailing orthodox policies to stabilize exchange rates.

Market structure and economic restrictions

9. The analysis of the structure of foreign exchange markets reveals further elements that restrict the scope for a Tobin tax. Such restrictions are mainly economical and relate to issues such as the level of taxation (tax rate, tax base), and to the distribution of tax revenue.

Tax rate

10. If the purpose of the tax is to be borne by traders/banks, the bid-ask spread will limit the margin for the rate. With the bid/ask being roughly one basis point for more liquid markets, the tax rate should not exceed half or one basis point.

11. If one assumes the tax to be shifted, it entails that it be borne substantially by non-banks. However non-banks represent only 13.3 percent of total turnover. It implies a leverage effect that could multiply the tax burden on non-financial agents by a factor of up to 7.5.

12. If the bid-ask is accepted to limit the scope of taxation, the uniform tax rate of a PFTT should then be derived from the conditions prevailing in the more liquid

markets. This confers a relative advantage to less liquid markets where the spread is higher. But this should be conceded because it favors the lesser industrialized countries. The tax rate should then fall in the range of one half to one basis point. The financial sector then likely bears part of the tax.

13. At this level of taxation, there is no need to relieve exporters, importers or direct investors from tax.

Tax base

14. The tax base could consist of all spot transactions, and outright forwards and swaps up to one month. Options and other financial derivatives will not attract the tax directly, but they are taxed indirectly through the spot and forward transactions they trigger.

Partitioning tax revenue

15. The PFTT is inappropriate as a national revenue raising instrument. This results from the fact that foreign exchange transactions are carried out by time zone. Moreover there is a clear-cut trend toward centralizing these transactions at one center within the zone. This implies the tax to be implemented *for the EU as a whole*, including of course its main trading place, London, but also Switzerland as a potential rival within the zone, but outside the EU.

16. Tax revenue is collected by central banks, but it falls to the region as a whole, not to national authorities. It could be redistributed to national governments via formula-based transfers, but it should preferably go into a European Fund for Economic Development to be managed at the level of the EU. It is of course conceivable the revenue to be used for other „global public goods“ as well.

Operations

17. There is a number of positive factors that prevent foreign exchange transactions from migrating off shore into tax havens. These are the concentration of business onto one main financial center as a „natural monopoly“ within the time zone, complexities relating to foreign exchange transactions and their derivatives, as well as significant network externalities. However this is contingent on a tax policy that respects the specific features of liquidity trading and recognizes the effective margins of trading as a constraint on tax rates.

Implementation

18. The problems relating to the implementation of a PFTT are rather complex. First of all, there must be clear principles to guide tax policy. They concern the definition of the tax base and the taxpayer. A reasonable approach will be to base the tax on a “market principle”, whereby all traders accredited in European financial centers, centrally operating automated broker systems and clearing/settlement systems will be taxable. The same is true for foreign exchange trading by non-banks (such as Volkswagen or Daimler-Chrysler).

19. Generally speaking there are two options to define tax liability: at the trading desks, or at the time of settlement. Both procedures appear to be feasible, although they both have advantages and disadvantages.

20. If the tax is levied at the trading desks, there may be a cumbersome reporting necessity, which is inappropriate in view of the electronic platforms that characterize the market. This could be avoided by an automated,

centralized tax collection at the stage of clearing or settlement. The latter still poses problems as the available information is not passed on to the settlement stage now. Moreover, only spot transactions would be recognizable when settling claims.

21. However the further concentration and automatization of foreign exchange trading, in particular the introduction of a continuous link gross settlement system will significantly improve the conditions for levying the tax at settlement stage. This is why I prefer this latter approach. It requires a different principle of taxation though, which I have dubbed the "access principle". It defined tax liability from the access to official national gross settlement systems, with contractual „backward chaining" by which operations prior to settlement are included.

22. It seems obvious that this procedure will also require some reporting at the desk for those institutions that do not participate in official and centralized clearing and settlement. It could be waived however if those institutions would join such systems and/or convey relevant information into the centralized clearing and settlement machinery.

23. The ominous literature on tax avoidance strategies related to the introduction of a PFTT is by far overstating the risks. The high degree of concentration of foreign exchange operations tends to work against it. Developments in foreign exchange markets will further enhance compliance with the tax.

24. I consider a PFTT to be feasible in technical terms—provided that the nature of liquidity trading is respected and taken into account. There are even two options to implement such a tax, one starting form the trading desk, the other operating at the level of settlement. Both appear to be promising.

25. The knotty problems are not at all technical. They are related to political will, to international cooperation, and to legal enforcement.

Reactions

26. The introduction of a PFTT will entail a number of very different reactions among actors on foreign exchange markets. It is to be expected generally that trading volumes will decline, and that the bid-ask spread will widen. This raises the question of who will bear the burden of the tax. This question is largely open and controversial.

27. Most affected by the tax are those engaging in covered interest rate arbitraging. However, given the extremely thin margins of this business, it is likely that the higher risk will be largely shifted forward though higher premia. It implies the tax to be borne also by the production sector and by households (both private and public).

28. The proper speculators in the market, for instance hedge funds, will be hurt *comparably less* because they operate with significantly higher margins than liquidity traders. The tax adds only a relatively smaller charge onto their business. However they will have to fear the anti-speculative surcharge, which will not play a significant role in the trading decisions of all other groups.

29. Among the institutional investors, insurance companies will bear a comparably higher tax burden because of their longer-term investment strategies and the consequent lower rotation of turnover relative to assets. This is

different for the group of investment funds, for instance, where trading is comparably more intensive. Within this latter group of investors, it is most likely that those institutions can more easily shun the tax that specialize in financial assets of industrialized countries.

Revenue

30. Revenue estimates of a PFTT of one basis point result in an amount of 17 to 20 bill. Euro for the EU plus Switzerland.