Why the currency transaction tax
is a win/win scenario

A note from Susan George for the
Finnish Economic and Foreign Affairs Ministries
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NB: This note is based especially on the much longer and far more technical work of Sony Kapoor [a former and perhaps present banker: "Currency Transactions: A Report to the Tobin Tax Network"] plus the "Landau Report" of the commission established by the French government ["Les Nouvelles contributions financières internationales"] and Peter Wahl of the German NGO WEED ["International Taxation: Regulating Globalisation and Financing Development"]. Remaining questions could undoubtedly be sorted out by Kapoor who knows the responses to technical objections inside-out and has laid them out in great detail in the annexes to his report.

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THE BASICS: Proposals for a Currency Transaction Tax [CTT] have moved from utopian to mainstream in five or six years. Since James Tobin first made his proposal in the 1970s, much work has been done and many refinements added to the idea, which is why campaigners for the idea no longer refer to the "Tobin Tax" but to the **CTT**.

In Tobin's time, the **volume** of currency transactions [CTs] was about $80 billion a day; it is **now $1.900 billion per day**. Compare this **daily** figure with the value of world trade in goods and services which amounts to $9.000 billion **per year. Every day, currency markets handle more than 200 times the value of annual world trade.**

The **four major currencies** [dollar, euro, yen, pound sterling] make up **75 percent** of all transactions. Currencies of less developed countries are also traded but in small quantities. Most trades are realised in a few hours or at most a few days; the vast majority of positions taken [at least 75 %] are closed within a week. The positions taken to pay for actual goods or services at a later date represent +/- 2 percent of transactions; most trades are simply bets on the movements of relative currency prices.

Concentration in the CT market is high: **30 banks**, most of them American or British, are responsible for some **80%** of the trades. **Profit margins on CTs are thin** and **profits** for these important banks represent **$30-40 billion a year**. This is only **5-10 % of their annual profits**, a small share.

WHY DO WE NEED A CTT?

We need such a tax **first for financial market stabilisation and second to raise additional finances for development purposes**. Tobin thought of his tax as a device for attaining stabilisation and did not consider the money-raising or development finance aspects. Now it is clear that both are possible with a single instrument; the additional financing for development emerging in part indirectly **because** of financial market stabilisation and not merely from the CTT itself. .

I. STABILISATION: WHAT ACTUALLY HAPPENS IN CURRENCY MARKETS?

According to the ILO [“*Economic Security for a Better World*”, 2004] there were **over 90 serious financial crises between 1990 and 2002.** What actually occurs during a financial crisis? Traders [those of the 30 large banks, plus a few others] are rewarded when they “chase the trend” in the jargon of the *metier*. They will bet on the currency going in the same direction it is already going [generally falling] so long as the market provides no signal that this trend has reached its limit. The traders’ collective actions are self-reinforcing, but market incentive is structured so that “trend-chasing” is in their interest. These traders are not “evil speculators” but simply doing their jobs. If they do not “chase the trend”, they can lose or at the very least seriously spend down the risk capital allowed them by their bank. By not chasing the trend, they also reduce their bonuses and at worst lose their jobs.

In other words, **market destabilisation and “overshoot” are built into the system; markets are structured so as to produce necessarily extreme volatility**. The point is not to condemn the traders but to fix the markets to stop rewarding the behaviour they are obliged to adopt.

This built-in volatility of financial markets is the starting point for what is now called the Currency Transaction Tax; or sometimes the “**Tobin-Spahn” tax** [for its inventor, Professor Paul Bernd Spahn]. It combines the idea of a **tax on every trade at a very low level** [usually one basis point or one-tenth of one percent; 1/1000] **plus a “circuit-breaker” tax at a high, punitive rate** which automatically kicks in when the value of a given currency falls outside of a pre-established band [usually 2.5 to 5 % of an average based on a previous time period; Kapoor gives technical formulas for establishing such bands. [The idea is comparable to the bands of the European Monetary System or “serpent” that preceded the euro]. The circuit-breaker mechanism is like the one that automatically stops trading on the New York Stock Exchange if a stock plunges more than X percent in a trading day.

Some have objected to such a tax on grounds that it would require universal compliance by every country in the world to make it work. This is wrong. **The tax applies to the currency itself, not to the jurisdiction** [territory]. A little-known institution called the **Continuous Linked Settlement Bank settles FOREX transactions every day** and could easily collect the tax at the point of settlement--this is a matter of adding a few lines of software code. Furthermore, the **Central Bank issuing the currency is well aware of transactions in its own currency** and all foreign banks dealing in that currency hold "**nostro accounts**" with the Central Bank. **The decision of that Central Bank to tax all trades it its own currency [buying or selling] can perfectly well be unilateral and there is no need for universality**. The European Central Bank, for example, could decide tomorrow to levy a 1/1000 tax on all transactions in euros.

Some say that banks would want to evade the tax. In fact, **tax evasion at such a low rate is not worth the potential costs**--no Bank would risk losing its Charter for such a paltry amount of money.

Any reduction in currency trading on the part of these banks would simply be channelled into other financial activities--it would be up to governments to act in order to insure that these alternative activities contribute to the overall well-being of the currency and the country or region rather than to speculation and destabilisation. In any case, a very small transaction tax coupled with a circuit-breaker to prevent the financial collapse of vulnerable countries would be a public good in itself.

II. FINANCING FOR DEVELOPMENT

Financial market instability acts as a huge tax on investment, trade and development. The ILO estimates that such crises have resulted in 10 million more unemployed, including half a million in the United States, and probably as many in Europe, because trade and investment are penalised. Crises lead to high interest rates, often imposed by the IMF or simply applied because governments are trying to protect and make their currencies more attractive. High interest rates raise costs for business and discourage the housing-construction market. In the case of financial trading and "portfolio equity investment" the market does not allocate efficiently. During the crises of the late 1990s, Southeast Asia's growth rates plunged from an average of +7 percent to -10 percent .

Who would win with a CTT? Kapoor estimates the amount raised **directly** by a CTT would be around $10-15 billion with a tax fixed at one basis point or one-tenth of a percent. By itself, it would not solve problems of poverty, but combined with other measures such as debt cancellation and a unitary profits tax on Transnational Corporations [plus the indirect effects, see below], it could provide enough to change completely the development finance picture.

Indirectly, developing country governments would profit enormously from a CTT. For example, the government of Brazil holds $50 billion in FOREX reserves because it feels obliged to guard against any repetition of financial crisis. These reserves are placed in low-yield OECD government bonds which bring in perhaps $ 1 billion a year, whereas Brazil is paying back interest on its debts at about 13%. By holding its FOREX reserves and not placing them in more lucrative instruments or investing them in health, education, etc. Brazil is forgoing [according to some calculations] about 1 percent of its annual GDP. Worldwide, developing countries hold at least $1500 billion in FOREX reserves. These reserves are maintained primarily to forestall attacks on their currencies. They could cut these reserves, say, in half if a tax guaranteeing greater stability were in place. Reduced volatility on financial markets would free up huge amounts of potential finance for investment in health, education, etc.

More jobs would be created and governments would enjoy a broader tax base. At present, business all over the world is also "taxed" because of uncertainty regarding currencies. For example, businesses in the developed world now have to hedge against currency volatility losses which increase the costs of investing abroad. Toyota is said to spend about $250 million a year on hedging against currency losses. Several mining companies which did not hedge have sustained large losses. Business would also profit from paying lower interest rates.

Arguably, **even the Banks would gain**. First, they could easily accommodate a tax at the low level of one basis point [1/1000]: recall that the **CTT is a tax on volume, not on profits**. The Banks' profits on CTs would probably be reduced but they could make up for that because there would be more Foreign Direct Investment, more business borrowing and more rewarding investment in other areas..

III. IMPLEMENTATION.

Belgium has already passed well-thought out Tobin-Spahn CTT legislation which could be used as a template by other countries, especially European countries, wishing to do the same. The Landau Commission and the subsequent decision by the French and other governments to launch an airplane ticket tax shows that international taxation is possible. President Chirac's "thank-you" letter to the French Attac economist who participated in the Commission pointed out that it was now established that a CTT was "economically rational and technically feasible". The endorsement by over 100 heads of State and government of the idea of a CTT, presented by the French, Spanish, Brazilian and Chilean governments at the UN Special Session in September 2004, shows that this idea is now well beyond the category of utopia.

At least two major **problems** remain. One is that the **United States** would almost certainly refuse to join, but the impact of its decision would be limited because American banks would still have to pay the tax on buying/selling the Euro or the pound anyway. The **European Central Bank** with its totally independent status **might see the measure as an obstacle to "free and undistorted competition"** which was omnipresent in the European Constitutional Treaty. Various articles in the ECT would have made the CTT unconstitutional; this was one of the reasons Attac and other NGOs opposed it. However, **the Eurogroup of Finance Ministers could make a decision on their own to levy a tax on euro-trades** and, if necessary, even sidestep the ECB in Frankfurt.

The question of "**who allocates**" and **how to avoid corruption** has been solved for the airplane ticket tax, which is overseen by a small, new UN agency [UNAID]. A limited corps of independent auditors-inspectors should be established.

The best way to insure the proper dispensing of new [or for that matter old] aid for development would be to link its delivery to **the election in the receiving countries of local councils** with both geographic and sectoral representation so that all areas and interest groups of the country concerned was represented [women, farmers, trade unions, entrepreneurs, teachers, health professionals, the army….]. **Such councils would amount to replacing IMF-World Bank conditionality through imposed structural adjustment policies with "democratic conditionality".** These councils, sitting alongside the government, would decide upon development aid priorities for their own countries and oversee the dispensing of the funds, along with a dedicated UN auditor [not a national of the country concerned]. The model here is the Brazilian participatory budget schemes which have reduced waste and corruption to near zero.

The objection is sometimes voiced that the worst governments would refuse to allow the election of such councils and therefore their people would be penalised. Yes, they would be penalised--but perhaps only for a short time. When the government and the people saw neighbouring countries receiving and dispensing serious new money, it might concentrate their minds wonderfully.