

■ Tobin tax

Nobel Laureate economist James Tobin (1974, 1978) advanced a now well-known case for what has come to be known as the Tobin tax, namely, the imposition of a modest ad valorem tax (i.e., a percentage of value) on all spot transactions in foreign exchange. (Spot transactions are those that entail actual exchanges of currency at the existing market rates.) Tobin wrote that “the tax would apply to all purchases of financial instruments denominated in another currency. It would have to apply . . . to all payments in one currency for goods, services, and real assets sold by a resident of another currency area” (1978, 159). Tobin advanced the case for this tax on currency trading following the collapse of the Bretton Woods system of pegged exchange rates and attendant concerns about speculation, volatility, and misalignment in currency markets. Tobin also suggested that the tax could restore “some fraction of short-run [policy] autonomy”; however, he was careful to explain that “it will not, should not, permit governments to make domestic policies without reference to external consequences” (1978, 158).

The Tobin tax built on John Maynard Keynes’s case for a securities transactions tax. Keynes (1936) proposed a substantial transfer tax on all transactions as a means to dampen the general tendency for speculation to dominate enterprise in liquid, competitive financial markets. Keynes (1980, chap. 36) also proposed taxation of foreign lending to contain speculative capital movements.

Several factors stimulated interest in the Tobin tax in the 1990s. These factors included the increase in currency speculation and volatility; the frequency of currency crises in developing countries; and the debate over the adequacy of the international financial architecture and the volume of international capital flows available to developing countries. This attention stood in sharp contrast to the silence that greeted Tobin's original presentation in the 1970s. The recent interest in the Tobin tax is located in a number of quarters—namely, academic economists identified with the Keynesian tradition, various United Nations agencies, governments in some countries that express support for the Tobin tax (namely, Canada, Belgium, and France), and nongovernmental organizations concerned with development finance and financial architecture. Tobin distanced himself from many of the nongovernmental organizations that advocated for the tax in the 1990s, however.

There is broad consensus that the tax must be levied at a low rate (Nissanke 2004 suggests 0.01 to 0.02 percent) in order to minimize the incentive to undertake tax evasion strategies (e.g., geographical or asset substitution) and to avoid other distortions of the foreign exchange market. Research has also focused on the issue of tax collection. In Tobin's original formulation, governments would levy and collect the tax nationally. But in view of the potential problems of tax competition among nations and the diversion of trading activity to "Tobin tax havens," many proponents focus on the need for a global tax agreement and the creation of a supranational authority to administer and collect the tax (Griffith-Jones 1996) and to allocate its revenues to projects that promote development (Kaul and Langmore 1996). Others, however, suggest that a Tobin tax could achieve some of its objectives absent global implementation (Baker 2001; Nissanke 2004).

Modifications to the Original Tobin Tax Concept In 1996 Tobin amended his original proposal to take account of the importance of new instruments of foreign exchange trading. In the amended version, Tobin (1996) argued that forward and swap transactions would be subject to taxation as well. (A for-

ward transaction is a contract in which parties agree to exchange currencies in the future at a price agreed on today. A swap combines spot and forward transactions.) Indeed, it is likely that if the tax is limited to spot transactions it would lead to a tax-saving reallocation of financial transactions from traditional spot transactions to derivative instruments. As such, in order to prevent tax avoidance via asset substitution or a changed product mix, it ought to be applied on all derivative products such as forwards, futures, options, and swaps.

Some proponents of the Tobin tax argue for modified versions of the proposal aimed at enhancing its ability to reduce currency market volatility. For instance, Crotty and Epstein (1996) argue for joint implementation of Tobin and securities transaction taxes. They argue that a securities transaction tax might reinforce the market-stabilizing function of a Tobin tax by increasing the cost of investor flight (since the sale of assets or borrowing must precede the flight of large sums of money from a country).

Spahn (1996) advances a case for a two-tiered Tobin tax. In this formulation, low transactions taxes on currency trading would be maintained during tranquil (or "normal") times. But a higher transaction tax would be activated whenever levels of market activity accelerated dramatically. Spahn argues that with knowledge of this variable tax structure, investors might be less likely *ex ante* to engage in activities that aggravate various types of financial risks. Moreover activation of a prohibitively high transaction tax (as a type of speed bump) might discourage some investors from liquidating their portfolios at precisely the time of greatest financial volatility.

The Debate over the Tobin Tax Most proponents of the Tobin tax argue that it has the potential to shift the balance of factors influencing the exchange rate away from short-term expectations toward long-term factors and to decrease exchange rate volatility caused by speculation in this market. Advocates maintain that speculation in currency markets would be dampened because the annualized cost of even a low tax could change trading behavior. Many proponents argue that the Tobin tax consti-

tutes a progressive form of taxation, given its likely incidence (Baker 2001; Palley 2001). Following the East Asian financial crisis of 1997–98, a few advocates suggested that had a Tobin tax been in place it might have reduced the buildup risks that culminated in the crisis (Wade 1998).

Advocates of the Tobin tax are sanguine on the matter of revenue creation. For instance, Nissanke (2004) forecasts that a Tobin tax (even if not implemented by all countries at once) has the potential to raise between U.S. \$17 billion and \$35 billion in one year (using data for 2001). The taxes harvested would be allocated to various projects of developmental or global importance.

Critics of the Tobin tax, such as Dodd (2003), advance a number of arguments. Dodd argues that the tax is not politically feasible; that it is not feasible administratively or technically without imposing unreasonably high costs; that the issue of leakages through shifts to nontaxed assets and/or to Tobin tax havens is not considered seriously; that the tax would have perverse consequences insofar as it would reduce financial market stability and increase volatility in prices and capital flows; and that the proposed rate for the Tobin tax is actually quite large when one compares it with the transaction costs of trading in foreign exchange markets and most liquid securities and derivatives.

Critics have also taken issue with the claim that the Tobin tax could play any role in reducing the tendency toward financial crises in developing countries (Gabel 2003). This is because the Tobin tax is not designed to dampen speculation in all of the sectors of the economy that are prone to bubbles (e.g., real estate and construction). Even in those sectors that do fall under the authority of the tax, the presence of a tax is unlikely to undermine the attractiveness of activities and financing strategies that aggravate fragile financial environments. Implicit in this critique of the Tobin tax is the view that other strategies—ranging from prudential financial regulation, exchange controls, capital controls, capital management techniques, and taxation of other “global public ills” (such as pollution)—represent far better means than does the Tobin tax for reducing

financial volatility and currency misalignments, enhancing macroeconomic policy autonomy, and raising revenues for projects of global social importance.

See also Bretton Woods system; capital controls; capital flight; currency crisis; exchange rate volatility; financial crisis; global public goods; international financial architecture

FURTHER READING

- Baker, Dean. 2001. “Why Do We Avoid Financial-Transactions Taxes?” *Challenge* 44 (3): 90–96. Focuses on the politics of the Tobin and other types of financial transactions taxes and argues that the primary obstacle to serious consideration of these measures is political, rather than technical or economic.
- Crotty, J., and G. Epstein. 1996. “In Defence of Capital Controls.” In *Are There Alternatives? Socialist Register 1996*, edited by Leo Panitch. London: Merlin Press, 118–49. Examines the economic and political arguments for various types of capital controls, including the Keynes and the Tobin tax.
- Dodd, Randall. 2003. “Lessons for Tobin Tax Advocates: The Politics of Policy and the Economics of Market Micro-Structure.” In *Debating the Tobin Tax*, edited by James Weaver, Randall Dodd, and Jamie Baker. Washington, DC: New Rules for Global Finance Coalition, 27–50. Presents a critical microeconomic and political analysis of the Tobin tax, takes issue with a great many of the arguments advanced by proponents, and focuses on the unanticipated negative economic and political consequences that would be associated with imposition of the tax.
- Gabel, Ilene. 2003. “Averting Crisis: Assessing Measures to Manage Financial Integration in Emerging Economies.” *Cambridge Journal of Economics* 27 (3): 317–36. Examines the ability of many policies (including the Tobin tax) to reduce financial instability in developing countries and concludes that the Tobin tax cannot reduce the most important types of financial risks confronting developing countries and, therefore, cannot reduce their vulnerability to crises.
- Griffith-Jones, Stephany. 1996. “Institutional Arrangements for a Tax on International Currency Transactions.” In *The Tobin Tax: Coping with Financial*

- Volatility*, edited by Mahbub ul Haq, Inge Kaul, and Isabelle Grunberg. New York: Oxford University Press, 143–61. Makes a case for the role of a supra-national authority charged with administering and collecting Tobin tax revenues.
- Kaul, Inge, and John Langmore. 1996. “Potential Uses of the Revenue from a Tobin Tax.” In *The Tobin Tax: Coping with Financial Volatility*, edited by Mahbub ul Haq et al. New York: Oxford University Press, 255–72. Argues that Tobin tax revenues should be allocated to projects that promote economic development.
- Keynes, John Maynard. 1936. *The General Theory of Employment, Interest, and Money*. London: Macmillan. Contains a brief discussion of the need to tax securities trading as a tool for reducing what Keynes saw as the tendency of speculation to dominate enterprise in liquid, competitive markets.
- . 1980. *The Collected Writings of John Maynard Keynes*. Vol. 6. *A Treatise on Money*. London: Macmillan. A brief passage in this volume contains the argument that foreign lending should be subject to taxation in order to reduce speculative capital movements.
- Nissanke, Machiko. 2004. “Revenue Potential of the Tobin Tax for Development Finance.” In *New Sources of Development Finance*, edited by A. B. Atkinson. New York: Oxford University Press, 58–90. Presents an estimate of the revenue-raising potential of the Tobin tax.
- Palley, Thomas. 2001. “Destabilizing Speculation and the Case for an International Currency Transactions Tax.” *Challenge* 44 (3): 70–89. Makes a case for the ability of the Tobin tax to reduce speculative pressures and presents a number of arguments from the public finance literature in support of the tax.
- Spahn, Paul. 1996. “The Tobin Tax and Exchange Rate Stability.” *Finance and Development* 33 (2) (June 24–27): 24–27. Advances an argument for a two-tiered Tobin tax.
- Tobin, James. 1974. “Prospects for Macro-economic Policy.” In *The New Economics One Decade Older*. Princeton, NJ: Princeton University Press.
- . 1978. “A Proposal for Monetary Reform.” *Eastern Economics Journal* 4: 153–59. In the 1974 and 1978 papers, Tobin articulates the case for a tax on currency trading, which later became known as the Tobin tax.
- . 1996. “Prologue.” In *The Tobin Tax: Coping with Financial Volatility*, edited by Mahbub ul Haq et al. New York: Oxford University Press, ix–xviii. In this short essay, Tobin updates his 1974 and 1978 arguments in light of changes in financial market structure.
- Wade, Robert. 1998. “The Asian Debt-and-Development Crisis of 1997–?: Causes and Consequences.” *World Development* 26 (8): 1535–53. Examines the causes of the East Asian financial crisis of 1997–98 and offers a brief counterfactual statement to the effect that a Tobin tax might have reduced some of the financial risks that contributed to the crisis.

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