A Synopsis of the Tobin Tax

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1. Introduction

In 1978, Nobel Prize-winning economist James Tobin described a strategy to reduce volatility in the foreign exchange market. Tobin’s proposition included a small, internationally uniform tax on all currency transactions. This tax would be allocated in proportion to the size of the transaction. The primary aim of Tobin’s tax is to act as a force against the power of speculative financial markets. Accordingly, the strength of the tax’s impact increases as the time horizon of the investment decreases.

This paper will examine the evolution of the Tobin tax. Section II provides a historical background leading up to Tobin’s 1978 proposal. Section III summarizes Tobin’s initial proposal and support for such a tax. Section IV provides a broad theoretical overview of the implications of the Tobin tax, with Section V presenting arguments both in favor and against the Tobin tax. Section VI concludes with a summary of the overall findings.

2. Historical Background

At the Bretton Woods Conference in 1944, several industrialized nations made an agreement in an attempt to stabilize currency exchange rates. Policy-makers unveiled a system of fixed exchange rates with the aim of promoting long-term investment and restoring trade in the postwar economy. In 1971, the United States abandoned the Bretton Woods system of fixed exchange rates opting instead for a floating exchange rate. This change implied that the US dollar was no longer automatically convertible into gold. As a result, the value of international currencies began to float freely in international markets.
After the collapse of Bretton Woods in the early 1970s, the world economy saw an increase in exchange-rate volatility. A number of economists found fault with this new floating rate regime, arguing that the floating exchange rate was the source of the economic volatility experienced in the 1970s. James Tobin recognized the discontent with the floating-rate regime, but asserted that the Bretton Woods system could not be restored and that floating rates were an improvement for the world economy. Tobin argued that the floating exchange rate was not the cause of the volatility. Currency speculation occurs in both types of exchange-rate regimes. The root of the problem, according to Tobin, could instead be found in overly efficient and powerful capital markets. The market required a different sort of mechanism to help cope with the volatility. Tobin argued that a transactions tax could partly fulfill this requirement.

3. Tobin’s Proposal:

In 1978, Tobin articulated his strategy to address the market instabilities in his presidential address at the conference of the Eastern Economic Association. Tobin argued that there were two options for the economy. One of those options was a common currency, along with a common monetary and fiscal policy. The other option was to pursue greater financial segmentation between nations or currency areas. According to Tobin, this second option would lend central banks increased autonomy in applying policies that could meet the needs of their specific economic institutions and objectives. Tobin did not see any promise for the first option of economic integration. Therefore, he recommended the second option of financial market regulation, proposing to “throw some sand in the wheels of our excessively efficient international money markets.”

practice, Tobin’s proposal amounted to an internationally uniform tax on all spot conversions of one currency into another. This tax would curb short-term financial speculative movements of currencies. The tax would act as Tobin’s metaphorical ‘sand’ clogging up the ‘wheels’ of the overly efficient money market.

In his book *Democratising Globalisation*, Heikki Patomaki (2001) parallels Tobin’s proposal with Keynesian economic theory. According to Patomaki, Keynes recognized that the foreign currency exchange market should be subject to taxation. Keynes argued for a tax on domestic financial transactions while Tobin argued for an internationalized version of the same type of tax. Tobin believed that international monetary problems are caused by factors external to the type of exchange-rate regime in place. Thus, arguments over exchange-rates evade the underlying economic problem of excessive international mobility of private financial capital.

4. Theoretical Justification and Explanation of Tobin Tax:

In the early 1970s there was widespread optimism that floating exchange rates would help stabilize markets. However, when currency crises arose, the proposal for a tax on international currency transactions became a more attractive option. Speculative attacks directed at major currencies during the 1990s repeatedly exposed the marketplace’s weaknesses in coping with excessive volatility. For example, Europe’s exchange rate mechanism crises from 1992-93 and the 1994 Mexican peso crisis could have benefited from the type of regulation Tobin proposed. According to Garber and Taylor (1995), the severity of the speculative attacks combined with the inability of the economy to respond smoothly has led to a widespread belief that the foreign exchange market is dominated by short-term speculators. Short-term speculation can cause
unnecessary and disruptive exchange rate volatility. As a consequence, these disturbances have helped turn the Tobin tax rationale into a more feasible and necessary strategy.

The Tobin tax efficiency rationale goes as follows. A tax rate of the less than 0.5% would be applied to all foreign currency exchange transactions. This would deter speculation on currency fluctuations. The minute tax rate would be low enough not to have a significant effect on longer term investment where the yield is typically higher. Instead, the tax is designed to cut into the yields of profit-seeking short-term speculators who constantly move large amounts of currencies on the international market to gain from slight interest-rate differentials.

5. A Survey of the Tobin Tax:

There is a vast literature both supporting and opposing the Tobin tax. Alex C. Michalos (1997) has written a comprehensive survey of both of these perspectives. What follows is a brief review of some of the arguments Michalos presents in his book, *Good Taxes*.

5.1. Arguments in favour of the Tobin Tax:

A common argument in favour of the Tobin tax is its potential humanitarian benefits. The Tobin tax has considerable revenue potential and if organized in a democratic and socially responsible fashion it could benefit low-income people. Some observers, like Patomaki, regard as unfair the idea that individual profits with socialized risks drive financial markets. Financial fluctuations can have serious consequences on those who are not involved in the financial market. The tax is therefore an innovative way to deal with this dilemma. As well, in comparison to regressive consumption taxes
like the GST in Canada, a Tobin tax is more progressive because relatively low income people are generally not involved in the activities that the tax aims to capture.

A second supporting view is that the tax provides managers with incentives to focus on relatively long-term investments. It can also induce shareholders to take a more active role in monitoring management, and it may insure that proper planning and investment activities are occurring. A third argument in favor of a Tobin tax is its ability to compensate for parts of personal and corporate income taxes that are lost because of tax evasion.

5.2. Arguments against the Tobin Tax:

Arguments against a Tobin tax commonly include problems of enforceability. The enforceability issue arises out of the potential that the tax can be evaded by moving transactions to tax-free jurisdictions. Additionally, an investor might substitute un-taxable transactions. This type of argument is generally supported by those who believe that attempts to regulate financial markets can often be avoided because market participants develop sophisticated methods to avoid the regulation. While an internationally uniform tax could improve tax-regulation, it is undeniably difficult to monitor all transactions and to force agreements among major countries.

Tobin believes on the whole that these are not significant obstacles to implementing a Tobin tax. A commonly cited example is the belief that a transactions tax will push business to tax-free jurisdictions such as the Cayman Islands. Tobin believes, however, that these scenarios have been exaggerated and that an agreement on the tax among the G-7 countries and a few other major financial centers could be sufficient for properly enforcing the Tobin tax.
6. Conclusion:

The currency crises in Europe and Mexico over the last decade have heightened interest in a mechanism such as the Tobin tax. The large degree of financial speculation that occurs in the market has a strong influence over national economies. These distortionary effects have increased the desire to find a tool that alleviates some of the economic turbulence. A tax that aims to curb speculation in foreign currency exchange is an innovative and fair proposal. There are vast benefits to be reaped by implementing such a tax. Not only would it reduce volatility and improve economic stability, but if the revenue is invested toward social development it will have overflowing effects in all parts of the economy. The feasibility of something like the Tobin tax, however, ultimately depends on how one defines efficiency in the foreign exchange market.
References


