

## Why a Two-Tier Tobin Tax Won't Work

JANET G. STOTSKY

***Financial market variability is a perennial problem for investors and policymakers alike. While attractive in some ways, a two-tier Tobin tax would not solve this problem and would have a number of undesirable side effects.***

**I**N HIS article in this issue of *Finance & Development*, Paul Bernd Spahn offers a creative extension on the Tobin tax idea. His proposed two-tier tax is designed to deal with a major problem of a Tobin tax, namely, if imposed at a high rate, the tax would seriously impair the normal operations of financial markets; while if the tax is imposed at a low rate, it would not deter currency traders who expect significant short-term changes in currency values. The top tier of Spahn's proposed tax—the exchange surcharge—would function as an automatic circuit breaker whenever speculative attacks against currencies occurred. Spahn argues that when the surcharge was triggered, transactions costs would rise enough to cause some traders to delay transactions, thus smoothing out changes in the value of the currency. Revenues from the tax might be allocated to the countries of origin, to an international body, or in some other fashion.

Spahn's argument in favor of such a tax rests on the assertion that imposing the high rate during speculative attacks would curb volatility, while the low rate that would apply during normal market condi-

tions would not impair market efficiency. He acknowledges that there are several important drawbacks to the proposal. The tax would apply to all transactions, without distinguishing stabilizing from destabilizing ones; it would be difficult to design the tax so that it applied equally to all financial instruments; and the allocation of revenues from the tax would be contentious.

Spahn faces an uphill battle in gaining acceptance for such an idea. There are the usual arguments against the Tobin tax itself to contend with. The main one is that there is little evidence that such taxes reduce market volatility—volatility could even increase. At the same time such taxes increase transaction costs and hinder the operation of financial markets. There would also be enormous administrative difficulties in implementing such a tax.

Spahn's proposal raises several other important issues. One issue is the desirability of using variable rate taxes. In practice, such taxes are rarely used. The main reason for their unpopularity is that they create uncertainty over prices in markets. This is, in fact, the feature of Spahn's proposed variable surcharge that could make it effective in altering market behavior. But at the same time, in the absence of volatility, the additional uncertainty it would create in financial markets is likely to impair their operation and increase spreads. Variable-rate taxes are also rarely used because they complicate considerably the burdens on taxpayers and tax administrations. This effect would be particularly severe in the case of a two-tier Tobin tax because the number of separate transactions to which the tax would apply is so huge.

A second issue is the advisability of mixing monetary policy with tax policy, given the different constraints under which each

operates. Monetary policy can change quickly and is generally somewhat insulated from politics. Tax policy changes only infrequently and political considerations are generally paramount. Spahn does not address either of these two issues, though they are crucial to assessing his proposal.

***Effect on market volatility and efficiency.*** Since Tobin taxes do not exist in practice, there is little empirical evidence to suggest that such taxes would be effective in reducing currency fluctuations, as Spahn asserts. Countries have used various forms of capital controls to reduce currency fluctuations, including implicit taxes such as nonremunerated deposits in the central bank. An extensive literature has examined how capital controls affect foreign exchange markets (see Dooley, 1995), reaching the broad conclusion that while capital controls may delay currency adjustments in the short run, they are ineffective in the long run. Similar conclusions have been reached in studies of the US stock market, where a variety of methods, such as circuit breakers and margin controls, have been employed to reduce volatility.

More generally, empirical observations do not provide a basis for asserting a firm link between transaction costs and volatility. Even in the past, when transaction costs in financial markets were generally larger than today, fluctuations in capital flows and prices were observed. In recent years, transaction costs have fallen significantly for participants in major foreign exchange and stock and derivative markets without any apparent increase in volatility.

The main argument against financial transaction taxes is that they reduce market efficiency, as Spahn acknowledges. Such taxes could impose a cost on financial markets by creating a disincentive to trade

Janet G. Stotsky,  
a US national, is an Economist in the Tax Policy Division of the IMF's Fiscal Affairs Department.

assets by inducing investors to hold a less desired portfolio and by potentially reducing stabilizing arbitrage. Moreover, these taxes would increase the cost of capital, and thereby lead to lower rates of capital formation and economic growth.

Since transaction taxes levied equally on all assets would effectively tax more heavily short-term assets and those traded more frequently, the most critical issue is the desirability of taxing short-term transactions more heavily. Proponents of financial transaction taxes have argued that short-term traders are precisely those whose activities are most destabilizing and thus advocate financial transaction taxes on the grounds that they would effectively target this group. The motivations of different traders in financial markets are not, however, well understood (see IMF, 1995, *International Capital Markets: Developments, Prospects, and Policy Issues*), and there is no way to target only destabilizing traders. The case for limiting the activities of all short-term traders is not persuasive.

**Intermediaries.** Financial transactions taxes would have a negative effect on the short-term liquidity trading of financial institutions, which rely heavily on trade in short-term financial assets to hedge currency and other investment risks and to provide liquidity to enterprises and individuals. Acknowledging this problem, Spahn suggests that the tax could exempt financial institutions and market makers. However, financial institutions and market makers are not necessarily stabilizing traders. In addition, exempting certain intermediaries would encourage their use by taxable market participants, irrespective of any advantages these intermediaries might provide.

**Cascading effects.** Spahn dismisses the efficiency effects of the low-rate Tobin tax that would apply under normal market conditions on the grounds that the tax would be negligible. Under circumstances of stable currency values, even what appear to be small tax rates on turnover may constitute a significant tax on the returns to trading financial assets in view of the narrow spreads that characterize foreign exchange market transactions. Even a 2 basis point (0.02 percent) tax on transactions value, as Spahn suggests, would result in a significant tax on the return to trading.

It is often assumed that taxes on turnover are shifted forward to the consumer and hence do not reduce the return to an activity. However, this is not likely to be the case with a tax on financial transactions, since

most financial transactions are undertaken by intermediaries. Taxes levied on turnover in this manner tend to cascade, so that the effective rate can be many times the nominal rate applied to a single transaction.

**Derivatives.** Derivative instruments have grown rapidly and are especially important in foreign exchange markets. Since investors can construct equivalent positions with derivatives as they would with cash instruments, transactions in derivatives should be taxed. It is difficult, however, to achieve equivalent taxation of cash and derivative instruments, as Spahn notes. His solution—to tax derivative transactions at one-half the standard rate—is not appropriate. Given the complexity of the strategies underlying the use of derivatives, it would be impossible to establish one rate for derivatives and one for the underlying instruments that would yield exact tax equivalences. Markets would quickly figure this out.

**Ease of avoidance.** Another fundamental problem with Spahn's proposal is that if a country were to unilaterally impose a financial transactions tax, it would be easily avoided. If transactions taxes applied to transactions only in domestic markets, investors could easily substitute foreign trading as a means to avoid the tax. For instance, a considerable amount of trading in US currency or equities takes place abroad. If financial transactions taxes applied to all currencies, traders could shift into vehicle currencies to avoid making currency conversions, increasing costs for small, not widely traded currencies and impairing monetary control in these countries.

In terms of the effective implementation of the tax, the mobility of financial transactions would make the tax easy to avoid unless the tax were internationally agreed upon and administered by each government. The effectiveness of the tax would be greatly reduced if only a few governments with major financial markets enacted it. Tax havens have proliferated in recent years. Such a tax would only add impetus to this trend. The rules for applying the tax would have to be established by an international consensus. But it has proven difficult to get countries to agree upon uniform taxation in other areas of taxation, even by relatively homogeneous groups of countries, such as the European Union.

**Use of revenues.** The use of the revenues from the tax is likely to be more contentious than Spahn suggests. The idea that the revenues could be used to support the United Nations, for instance, has

recently received an icy reception from US policymakers.

**Interaction between monetary and fiscal policies.** The introduction of even the simpler Tobin tax in major financial markets would entail significant administrative costs in developing methods for its collection, monitoring, and enforcement. The introduction of Spahn's proposed two-tier tax would be even more complex, requiring not only the apparatus of the simple tax, but all of the monetary policy considerations relevant to setting and maintaining exchange rates. The proper use of the tax would require a degree of cooperation between monetary and fiscal authorities that does not exist in practice. Compared with monetary policy, fiscal policy is generally determined in a far more constrained environment. It is doubtful that monetary authorities would have the ability and independence to administer such a tax wisely. F&D

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