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Comité Consultatif Economique et Industriel Auprès de l' **OCDE**

BIAC DISCUSSION NOTE ON THE TOBIN TAX

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International capital movements enhance the efficiency of economic activity and economic development. The rising volume of such movements, however, sometimes gives rise to concern since they are perceived to reduce the room of manoeuvre of national economic policy, increase exchange rate variability and make countries susceptible to currency and financial crises. Calls for a tax on financial transactions, a so-called Tobin Tax, derive from these concerns. A tax is also seen as a possibility to increase government revenues.

However, capital movements are not the reason for the problems perceived. On one hand, foreign trade, capital movements and cross-border ownership all restrict the independence of a country's economic policy, but on the other hand they are accompanied by significant benefits.

As long as national currencies continue to exist, there will be uncertainty about exchange rates. The character of the uncertainty depends on the exchange rate regime. A degree of volatility is inherent in all floating rates, as in asset prices in general. A system of fixed rates reduces exchange rate fluctuation, but is conversely susceptible to currency crises.

The biggest risks relate to short-term capital movements via the banking system. The idea behind the tax is that a low tax rate should be levied on all currency transactions. It is assumed that this would make the cost of short-term capital movements high but would not significantly affect the cost of long-term movements. The tax would make short-term speculation expensive, give domestic interest rate policy room for manoeuvre and reduce exchange rate volatility.

These objectives are, however, not likely to be achieved with a currency transfer tax. The tax might prevent speculative short-term capital movements in a situation where they would be unlikely, i.e. where there are reliably fixed exchange rates. At the same time, it would make other short-term financial transactions, such as hedging operations related to foreign trade financing, very expensive. In cases where the exchange rate target is not credible, the tax would not prevent speculative transactions.

A Tobin tax may actually increase the volatility in financial markets rather than reduce it. The tax may prevent a reallocation up to a point but once this point is reached, there is no reason whatsoever to abstain from reallocating the portfolio. The adjustment may therefore be postponed but once it occurs, it will be rapid and create substantial shifts in prices.

The tax would be difficult to control, private clearing operations taking place outside the banking system, and dealings in options and other instruments taking the place of *avista* transactions.

The best protection against financial crises and any excessive capital movements associated with them is a sustainable economic policy, a strong financial system incorporating efficient supervision of banks' risk-taking and capital adequacy, and watchfulness to ensure that the chosen exchange rate regime is compatible with free movement of capital. It is also important that the financial system ensure that those who take risks also carry adequate responsibility for any consequences in a crisis. It is therefore particularly important to develop the stock market in emerging economies. This will reduce the vulnerability of the financial system, because companies can use equity-based financing instead of debt and thus reduce their dependency on short-term capital imports.

The whole issue of capital controls is not relevant for the European Union or its Member States today. Ever since the signing of the Treaty of Rome, European countries have based their development strategy on free movement of capital. The Treaty forbids all restrictions on capital movements, both between Member States and in relations with third countries. The only way these principles could be abandoned would involve altering the Treaty. Rather than contemplating restrictions, the Community and its Member States should make sure that Europe's financial system remains stable amid rapid technological advances and structural change. Supervisory bodies should concentrate on monitoring the risks taken by European

banks in developing countries. It is in the interests of the Union's institutions and Member States to play an active role in processes aimed at strengthening the stability of the international financial system and at preventing crises. In particular, they should help the new candidate countries to modernise and consolidate their banking systems and financial markets so that enlargement can proceed without endangering the monetary and financial stability of the area.

BIAC does not support the approach suggested by the so-called Tobin tax.