IDS RESEARCH SUMMARY

Research findings at a glance from the Institute of Development Studies

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The Tobin Tax

A Review of the Evidence

The Tobin tax, a small levy on foreign exchange transactions, should theoretically discourage speculation and thereby stabilise markets. What is the evidence for and against Tobin and other financial transaction taxes regarding their impact on market volatility, their feasibility and the revenue they might produce, and who ends up paying?

The debate about the Tobin tax and other financial transaction taxes (FTTs) gives rise to strong views both for and against. However, little of the popular debate refers to the now considerable body of evidence about the impact of such taxes. This review attempts to synthesise what is known from the available theoretical and empirical literature about the impact of FTTs on volatility in financial markets. It also reviews the literature on how a Tobin tax might be implemented, the amount of revenue that it might realistically produce, and the likely incidence of the tax.

According to theoretical models an FTT should reduce volatility by reducing the number of speculators, although if the tax is too large, the reductions in market trading and liquidity could increase volatility. Most empirical studies, and the few studies of actual transaction taxes, find that higher transaction costs are associated with more, rather than less, volatility.

There is some consensus on how the tax should be designed, with a preference for its application to a broad range of financial instruments to avoid a shift to untaxed instruments, and the need to differentiate the tax rate by instrument and market to ensure that it corresponds to around the same percentage of transaction costs in each market.

Disagreement centres on whether the tax should be at the decentralised point of trade, with international agreement necessary to prevent migration to non-compliant jurisdictions, or at the increasingly centralised point of settlement, enabling implementation by individual countries or groups of countries without a full international agreement.

Estimates of potential revenue depend on which markets are taxed, the rate of taxation and the reduction in trade caused both by the tax and by avoidance. A meta-analysis using the median estimates from the literature finds that applying a 0.005 per cent tax to the foreign exchange market alone might raise US$25 billion annually worldwide and £7.5 billion for the UK.

Wholesale traders are likely to bear the initial cost, but the final incidence would depend on the extent of competition in different segments of the financial sector. A significant proportion of the tax could end up being passed on to consumers. However, since most households earn relatively little of their income from returns to capital, it is likely that an FTT would be more progressive than several other forms of taxation, e.g. VAT.

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Key research findings

1. Theoretical models suggest that FTTs reduce volatility but most empirical evidence shows that higher transaction costs are actually associated with more, rather than less, volatility.
2. It is now much easier for countries to unilaterally introduce certain forms of FTT, e. g. a currency transaction tax, because of a shift towards centralisation, formalisation and regulation of settlement sites.
3. A small tax on foreign exchange transactions could yield relatively large sums of revenue. Applying an FTT to other markets, such as derivatives and over the counter, would be much more difficult but, if successful, could raise much larger sums.
4. Although wholesale traders would bear the initial cost of the tax, in the long run a significant proportion of it could be passed on to consumers. However, it is likely that an FTT would be more progressive than several other forms of taxation and no more difficult to collect.

Although the evidence is not conclusive on all points, an FTT is clearly implementable and could make a significant contribution to revenue in the major financial economies. It would be unlikely to stabilise financial markets but, appropriately designed, also unlikely to destabilise them. Although a multilateral agreement between the key economies is preferable, it could be implemented unilaterally, at least for a major economy. The incidence of a Tobin tax would be less progressive than some of its proponents claim, but it would be unlikely to be significantly worse than most alternatives.

Credits

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