

Ready for Implementation

Technical and Legal Aspects of a Currency Transaction Tax and Its Implementation in the EU

Bruno Jetin / Lieven Denys

EXECUTIVE SUMMARY

This study brings the important technical and legal details of the Currency Transaction Tax (CTT) to the debate table. It proves explicitly the feasibility of a CTT implementation and clarifies its political, technical, institutional and legal aspects. It is, so far, the most in-depth analysis of the possibilities of an implementation of the CTT and the challenges emerging from this implementation.

Eventually the implementation of a CTT depends on the political will and especially the pressure by the global justice movement on governments and decision makers. The technical feasibility of a sound project does not ensure its implementation, as politics are shaped by interest groups and power struggles. However, this study shows that there are no more formal, legal or technical excuses behind which opponents or hesitant supporters of a CTT can hide.

PART I: TECHNICAL, INSTITUTIONAL AND POLITICAL ISSUES

1. Chapter: THE CASE FOR A CURRENCY TRANSACTION TAX

In the first chapter, Bruno Jetin introduces the concept of the Currency Transaction Tax (CTT). After the Bretton Woods system of fixed exchange rates was abolished and substituted by a non-system of freely-floating currencies, the volatility of currencies and financial markets became one of the major sources of crises, especially in the developing world. James Tobin's idea of a currency transaction tax ("Tobin tax") was aimed at curbing volatility and preventing financial crises. More generally, the CTT is designed to restore national policy autonomy by governing the international foreign exchange market. The author comes to the conclusion that "exchange rate volatility matters" because it negatively affects economic growth, international trade, investment, employment and wages. This is not only the case for developing countries with weak currencies, but also true for huge markets with strong currencies like the Euro zone.

Exchange rates can be stabilized in different ways: by international cooperation in economic policies, by creating a "world currency", by creating "target zones" for currencies, by capital controls and finally, by a CTT. The pros and cons of each method are discussed. The idea of a world currency is rejected as politically problematic and a step back from a perspective of social justice and democracy. The concept of target zones for currencies is supported as an important instrument, but defending the target zones by central banks without any restriction to capital mobility is seen critically because currency volatility might be substituted by interest rate volatility. By limiting inflows and outflows of capital,

the CTT turns target zones into a viable instrument of exchange rate policy. Capital control is also a concept that is supported, but rather as a part of a new international financial system than as a measure for short term reforms that any country could enforce unilaterally indefinitely.

The CTT is an effective concept to curb currency volatility and to fight speculation. In contrast to nationally applied capital controls it also has the advantage that it is an international tool that can open a perspective for more international political cooperation in order to govern economic globalization.

When talking about the CTT the study more precisely refers to the two-tier currency transaction tax, which is a modification of the Tobin tax by Paul Bernd Spahn. The first tier is equivalent to the classical Tobin tax, with a very low tax on all currency transactions (e.g. 0.01%) focussed on the day-to-day currency speculation that derives profits from market volatility. This first tier is the main creator of revenues from the tax. However, the first tier is not able to prevent speculation during currency crises, because these huge currency fluctuations allow gigantic profits that would not be substantially diminished by such a low tax. This is where the second tier proposed by Spahn comes into action.

The second tier is a flexible tax rate that is only applied in the event of a currency crisis. It is used to tax away the profits from speculation and the windfall profits from large currency appreciations or depreciations. Following Spahn's definition, the tax is automatically applied when a currency leaves a defined exchange rate band. In combination, both tiers can effectively curb speculation, reduce the volatility on the currency market and prevent currency crises.

But the study makes departures from P. B. Spahn's proposal in several aspects.

The first tier should be much higher, up to 0.1%, even for currencies such as the euro, to more efficiently tackle the short-term volatility of currencies. The second tier should also be much higher, and even reach prohibitive rates in case of currency attacks. In such exceptional circumstances, the CTT could lead automatically to a temporary shutdown of the foreign exchange markets. This is especially important in developing countries. CTT rates must also be higher if one wants to keep alive the original reason why James Tobin invented the so-called "Tobin tax": preserving the autonomy of monetary policy. In today's global financial markets, deviating from the international interest rates that markets have decided condemn countries, and especially developing countries, to capital outflows and currency attacks. If a democratically elected government chooses an alternative economic policy based (among other elements) on low interest rates, it will be sanctioned by financial markets. The same is true for the EU member states if they opt for the "new economic policy" defended by some European radical economists. There is no other solution to this problem than endorsing the fact that market freedom, excessive liquidity and unconstrained arbitrage must be restricted. Higher CTT rates are a part of these restrictions.

Otherwise, there is no "sand in the wheels" at all, and these wheels are already far too well greased.

2.Chapter: THE FEASIBILITY OF THE CURRENCY TRANSACTION TAX

The second chapter deals with the feasibility and the technical implementation of the CTT. It offers the most detailed insight into the working of the forex market and the possibility of levying the taxes that have been published so far. It introduces some new innovations,

like an electronic tag that is applied to all currency transactions and makes them identifiable through all stages of the transaction. As a currency transaction involves several actors, stages, monitoring and clearing systems, the tag helps to identify each transaction and ensures that the tax is paid. Thus each currency transaction can be identified

and monitored at a very early stage and the tax can be paid at each stage or at the final one, when currency transactions have already been netted and are settled through an electronic system.

It is important to realize that the introduction of the CTT benefits from technical progress and the centralization of the forex system. Today, the electronic brokerage platforms EBS and Reuters handle nearly all the forex trade. Such a centralisation has always been suggested by proponents of the CTT and previously seemed unrealistic – but has now been achieved by market forces. Nowadays, collecting the CTT would be as easy as paying the commercial fees for the use of these private electronic platforms. Other electronic systems like SWIFT manage the exchange of information between the trading parties, provide the necessary information for the netting (also called clearing) of transactions, and their settlement in national payment systems, European payment systems like Euro 1 or TARGET, or international payment systems like CLS. Institutions that trade currency, or settlement institutions like the CLS bank have to cooperate with the central banks, and thus can be committed to levy the tax.

Legal issues are also discussed. As the business of forex transactions is considered to be an investment business by European law, it is no problem to tax the transaction in legal terms. However, it does not make sense to levy the tax just in one country – rather, an implementation at the EU level would be appropriate. The already existing EU legislation could be mobilised in this perspective. Although tax evasion might still be possible, it is shown that this would be a minor difficulty at most. It would be possible to move the forex market somewhere else, but to put this into reality is not easy. London is the most important marketplace for currency transactions, and one of the most expensive cities in the world. Would a small tax like the CTT make a difference? The forex market needs a good infrastructure which only a few cities can offer. Most importantly London has the geographic advantage of having overlapping working hours with the two other important economic regions: North America and East Asia. This is crucial for an effective and inexpensive settlement process.

Another argument supports the feasibility of the tax, and that is the Security Transaction Tax (STT) that is levied by several EU member states like the UK, Ireland and Belgium. The STT is automatically collected through the settlement systems - a method that could be used by the CTT as well. It is important to know that the EU institutions are not asking these countries to suppress STT taxes, but to let foreign firms compete in collecting the tax in an increasingly efficient way. Finally, anti-money laundering measures can be used to identify currency transactions, as shown in a detailed analysis by the recommendation of the G7 Financial Action Task Force (FATF). In this field again, it is important to observe that the EU has adopted a comprehensive legislation against money laundering, which goes deep into the practical details of forex and other financial transactions that take place in the EU. SWIFT, the major information conveyor of forex transactions, had to change the content of its message to respect this EU legislation. Due to these changes, all the information needed to tax currency in the EU is already at the disposal of member states.

3.Chapter: FISCAL REVENUES, THEIR MANAGEMENT AND USE

The third chapter estimates the revenues of the CTT and offers proposals on how to manage and spend them. The original purpose of the CTT was not to create revenues, but to curb speculation and stabilise the currency market. However, as with taxes on tobacco or alcohol there is no principle contradiction between creating revenues and sanctioning behaviour with negative consequences for the society. A huge number of studies are presented that estimate the potential revenues from the CTT. Different scenarios and calculations are used that estimate the revenue worldwide from \$19 billion to \$31 billion for a

tax rate of 0.01%, and \$34 billion to \$125 billion for a rate of 0.1% in 2004. For the Euro zone, the estimates range from \$6 to \$10 billion for 0.01% and \$10 to \$46 billion for 0.1% in 2004. The author also calculates revenues for split tax rates of 0.02% for banks and 0.1% for customers, as banks would have a very high elasticity on the CTT. This scenario would result in revenues of US\$ 97.4 billion at world level and between \$29 and \$38 billion in the Euro zone.

Revenues should be used to finance global public goods and development in the poorer countries, not to consolidate national accounts in the industrialized countries. The author proposes to spend the revenues for the establishment of a reserve currency fund in order to achieve the public good of more exchange rate stability, as well as for the funding of ecological and social programmes in order to achieve the public good of sustainable development

and social security.(e.g. the fight against tuberculosis and malaria would cost around \$2 billion, and against AIDS \$7-10 billion). The UN estimates that satisfying the needs in global public goods would probably require a minimum of \$20 billion a year. The author also pleads for an international emergency fund for disasters.

The third part of chapter 3 deals with the important institutional aspects of who will collect the CTT and distribute the revenues. It is argued that the tax should be collected by established institutions on the national level. For the management of the revenues, different existing organisations like the UN, UNSOC, UNDP, UNCTAD, IMF, World Bank and BIS are discussed and rejected. The solution proposed is to establish a new organization, which could be called the "Solidarity Fund for Sustainable Development", and which cooperates with national governments and the BIS concerning the levying of the tax. and with UNDP and UNCTAD concerning the distribution of the revenues. A detailed concept of the governance structure of the fund is presented.

The principle should be that poor countries receive more funds in the beginning. However, funds would be linked to performance criteria, such as an improvement in human development, gender related development and ecological sustainable development.

PART II: LEGAL ISSUES

4.Chapter: THE IMPLEMENTATION OF THE CURRENCY TRANSACTION TAX IN THE EU LEGAL CONTEXT

The fourth chapter by Lieven Denys deals with the implementation of the CTT in the legal context of the EU. It also elaborates on the opportunities available at the EU level to ensure correct application of the tax and prevent fraud. The conclusion of this chapter is that a CTT is in line with European law.

First of all, it inquires on possible contradictions of national CTT laws and EU law.

This is done for the case of the Belgian CTT law passed by the Belgium parliament on July 1st 2004 and in whose formulation the author participated. The author disproves criticism on the Belgian CTT by the ECB and the European Commission. From the institutional perspective,

it can be concluded that the EU has no exclusive competence in indirect taxation and that Member States are thus free to introduce a CTT. Tax disparities are not prohibited by EU law. The Member States have indeed in principle the right to introduce new indirect taxation, until the EU enacts measures in that area.

Since the EU has exclusive competence in the area of monetary policy for the Euro Member States, the second tier of the CTT would need approval of the EU. The second tier of the CTT is a monetary surcharge in order to prevent harmful currency fluctuation and thus an intervention in monetary policy. Therefore, it would have to be regulated by the EU.

The author proves that the CTT is compatible with the European non-discrimination

principle. The CTT is not discriminatory because it taxes all currency transactions regardless of the currencies involved and regardless of the nationality or residence of the trading parties.

The second potential problem is the compatibility with the Internal Market's four fundamental principles of freedom of movement. It is argued that the first tier of the CTT does not restrict capital flows as it does not distinguish according to the origin of the currencies involved nor their use (or destination). The legal principle of the free movement of capital is moreover not an absolute freedom: the first tier CTT is justified under the rule of reason by one of the fundamental EU objectives, i.e. (funding) development cooperation. Moreover the first tier does not affect access to the capital market, and the levy is too negligible to cause a restriction of free movement or to hinder the free internal market because of its very low rate of 0.02 or less. Indeed the financial markets can smoothly absorb the low rate levies. However, the case is different for the second tier of the CTT that restricts capital flows through a very high tax in the event of a large harmful currency fluctuation. Provided it is implemented as an EU monetary instrument, this second tier is justified in order to stabilize currencies and the economy. As a tool for monetary policies at EU level it is not in contradiction to EU law as international monetary stability is an important aim of the EU.

Next to the stabilization of currencies, financing development from the CTT revenues is the second important goal of the CTT. To improve financing for development is not only an important aim of the EU, but furthermore, the EU has explicitly committed itself to increase spending on developmental aid in order to achieve the UN Millennium Development Goals for 2015.

Finally the author proposes to introduce the CTT through an EU directive, similar to the EU VAT directive. This would bind EU member states to the introduction of a CTT but leave the details of implementation, as well as the administration, to the individual states. National and EU institutions like the central banks and the ECB could be instrumental in the implementation and expansion of the CTT to non-Euro member states of the EU and third states, including offshore centres and others, through a cooperation with multinational private financial institutions and settlement organisations, which they license to operate in the EU. EU anti-money laundering measures and the cooperation of Europol and Eurojust in criminal matters can effectively serve as the deterrent against the evasion of the tax.