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# Results Australia

***Creating the political will to end hunger and poverty***

1 July 1999

Mr David Hawker MP
Chair
House of Representatives Standing Committee on Economics,
Finance and Public Administration
Parliament House
CANBERRA ACT 2600

Dear Mr Hawker

Please find enclosed the submission by RESULTS Australia to the current inquiry by the House of Representatives Committee on Economics, Finance and Public Administration into *International Financial Market Effects on Government Policy*.

As the submission indicates, the interest of RESULTS Australia in this inquiry is primarily in the impacts of financial market instability on the poorest people, both through the impacts on poor people of high interest rates or rising import prices, and also through the limitation on the capacity of governments to undertake expenditure on basic services.

The submission highlights the option of imposing a low tax on international currency transactions as a means for both reducing the degree of currency instability and raising revenue that could provide for both additional expenditure on basic services and reduce other taxes.

Please contact me on (07) 3225 8772 during working hours, or by return e-mail, if the Committee requires any further information related to the submission.

Yours sincerely

Mark Rice
National Co-ordinator

**Submission by RESULTS Australia to the House of Representatives Standing Committee on Economics, Finance and Public Administration**

**Inquiry into the International Financial Market Effects on Government Policy**

**June1999**

## Introduction

RESULTS Australia is citizens' advocacy organisation with the objective of creating the political will to end hunger and poverty. RESULTS Australia's interest in the current inquiry by the House of Representatives Committee on Economics, Finance and Public Administration is in the impact that international financial market instability has on the policies that governments in both industrialised and developing countries pursue to provide services and income-earning opportunities to the poorest people.

The terms of reference for the Committee's inquiry concentrate on the constraints on the conduct of fiscal and monetary policy by the Australian Government, and on the international regulatory responses to instability in international financial markets. The greatest impact of the recent financial crises, predominantly in Asia, has been on the poorest people in the countries immediately affected. Therefore, the most important policies that the governments of Australia and other OECD countries could put in place are those that could reduce currency instability and provide governments with additional revenue to provide services to the poorest people.

One proposal that could achieve these goals is to apply a tax at a low rate to international currency transactions, as proposed originally by Professor James Tobin in 1972. This proposal is gaining increased international interest, including gaining majority support in a motion in the Canadian House of Commons in March 1999.[1] The following sections discuss this proposal in more detail.

## Costs of Currency Instability

Having flexible exchange rates can be helpful in assisting countries achieve economic goals: in principle, a floating currency can allow a national government to pursue goals for economic growth, controlling inflation or promoting employment, without compromising these goals by maintaining a particular exchange rate. For example, if Australia suffers a decline in export prices, a fall in the value of the dollar would cushion the impact of this decline on the domestic economy.

Large or sudden currency fluctuations, however, can have significant and lasting negative impacts on economic and social conditions in the countries affected. A sudden increase in the value of a country's currency can undermine the competitive position of exporters or import-competing industries. The impacts of a rapid decline in a country's currency are more severe: the prices of imported goods and the cost of servicing loans denominated in foreign currencies.

[1] Private Members' Bill M-239, 24 March 1999

An initial policy response by governments and central banks is to use foreign currency reserves and raise interest rates to attempt to stem the fall in their currencies' value. If these measures are unsuccessful, governments may need to call on the IMF to replenish foreign currency reserves. This support comes with conditions attached, usually involving measures to cut budget deficits (including reductions in social expenditures), further increases in interest rates and mergers and closures of heavily-indebted firms in the financial and industrial sectors.

Rapid currency depreciation's have their greatest impacts, predictably, on the poorer members of the population, who are most likely to feel the effects of higher prices, reduced government spending and job losses.

In many cases, countries whose currencies come under speculative attack do need some currency depreciation, and make other changes to the financial and industrial sectors, but the response to currencies in free-fall leads to these changes being made in a disruptive and damaging way.

The Australian dollar is one of the most frequently-traded currencies in the world, and in 1997-98 the average daily turnover on the foreign exchange markets in Australia was $28.7 billion[2], vastly exceeding the value of Australia's trade in goods and services. This makes Australia vulnerable to speculation and perceptions of adverse economic developments.

In addition, Australia's exports have suffered due to the decline in the economies of trading partners which have been most affected by currency instability. In 1997-98, Australia's combined exports to the ASEAN nations, the Republic of Korea and New Zealand declined by $2 billion from the previous year, as these countries suffered either directly or indirectly from financial crises.[3] This illustrates the value to Australia of addressing currency instability on a global scale.

**Ways of Dealing with Currency Instability**

Several options for addressing currency instability, including having a common regional currency, as in Europe, or the imposition of restrictions on short-term financial flows, as in Chile since the early 1990s, have been adopted in some countries. It may be impractical, however, for other groups to adopt a common currency in the near future, and controls on short-term currency movements tend to be tailored for each country's circumstances.

The option highlighted in this submission, a tax on international currency transactions, has the advantages that it could be adopted by all governments and could provide a substantial source of revenue that could be used to reduce other taxes or fund high-priority expenditures. This type of taxation was originally proposed by Nobel Prize winning economist, Professor James Tobin. The principle of such a tax is simple: international currency transactions would be subject to a tax at a low rate and the level of revenue that would accrue to each governments would depend on the volume of turnover on their foreign exchange markets.

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[2] Source: *Reserve Bank Bulletin,* May 1999, p. S50.
[3] Australian Bureau of Statistics, *Australian Economic Indicators,* June 1999.

Tobin has suggested that such a tax could be imposed at rates of between 0.1 and 0.25%. At a rate of 0.1%, a tax on international currency transactions would raise from an estimated $US 148 billion to $166 billion per year ($A 225 billion to $250 billion).[4]

The benefits of imposing a tax at a low rate on currency movements would be two-fold:

- International currency transactions rely on very small margins (differences between the buying and selling price), so the imposition of even a very low tax rate would make many short-term transactions unprofitable. Therefore, the volume of currency transactions would decline.
- The level of revenue that such a tax would raise would be more than sufficient to provide basic services, including primary education, basic health and water supply and sanitation, to all people in the world. The estimated additional expenditure to provide these services to all people within 10 years is $US 70-80 billion per year.

***Implementation Issues***

The implementation of a tax on international currency transactions would require several issues to be resolved among participating countries:

- All countries with currencies traded actively would need to agree to participate in the imposition of the tax. Without this agreement, currency trading would be diverted to countries that did not impose the tax, reducing the revenue that participating governments could obtain, and reducing the potential benefits of currency stabilisation from the tax.

- Countries imposing the tax would need to agree on the collection and use of revenue from the tax. A model that is likely to increase support for such a tax is that each government would collect revenue on currency trading occurring on its markets, and could retain most of the revenue for domestic purposes. One suggestion is that each government could retain 80% of revenue for domestic purposes (either additional expenditures or reductions in other taxes), with the balance devoted to official development assistance (ODA) and other international co-operation, such as for peace-keeping operations and environmental projects.[5]

One limitation that supporters of the concept of a tax on currency transactions have conceded is that it may reduce the smaller fluctuations in the value of national currencies, but would be insufficient to prevent major runs on currencies when investors lose confidence.[6] This may be accurate, as the imposition of a low tax would not change the views of currency traders about the strength of a country's economy. However, it would assist in reducing the wide swings in currencies that do not seem to be justified by the fundamental economic situation in an economy.

Nor does the imposition of an international currency transaction tax remove the requirement for governments to pursue economic policies that would lead to sustained economic growth, low inflation and interest rates, and a sustainable trade balance. In fact, governments may be able to focus on achieving longer-term economic objectives more effectively if they are less concerned about currency instability.

Another challenge the introduction of a tax on currency transactions is that it would add to the costs of financial institutions and dealers that engage in currency trading. If these institutions pass on the costs to clients (through changes in transaction fees or interest rates) the imposition of this tax would have some impact on the costs and prices for other goods and

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[4] M. ul Haq, I. Katil, I. Grunberg, *The Tobin Tax, Coping with Financial Volatility*, 1996, p.63

[5] I. Kaul and J. Langmore, *Potential Uses of the Revenue from a Tobin Tax,* from ul Haq, Katil and Grunberg, 1996.

[6] The Canadian Minister for Finance, Mr Paul Martin, said of a foreign currency transactions tax in March 1999 that "If it was as small as people say, I don't think it would work."

services. This cost could be addressed by using some of the revenue from the tax to reduce other taxes, thereby offsetting the net impact on business costs.

***Australia's Role in Building International Support***

Introducing a tax on international currency transactions would require the support of the major industrialised countries which are the centres for the majority of currency trading. Therefore, the forum at which this proposal would be most likely to be advanced is the annual meeting of the Group of 8 countries (the G-8). Australia can play a role, however, in advocating consideration of this measure when Ministers and Members of Parliament meet their counterparts from G-8 countries, and at the meetings of the international financial institutions (the International Monetary Fund and World Bank).

As the Australian dollar is one the world's most actively traded currencies, Australia has a legitimate interest in promoting measures that would address currency instability. This could have the benefit of reducing Australia's direct vulnerability to currency speculation and assisting the economies of trading partners that have suffered most in the last two years.