Innovative sources of financing for development:
The Currency Transaction Tax

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The Currency Transaction Tax (CTT) is one of the new mechanisms being considered by many governments, international institutions, and others to raise large amounts of independent, global, and stable monies. The revenues are to be used to finance international development and other projects addressing global issues, such as public health. Of the possible new sources of finance for development, the CTT is the most immediately practical and effective. It is easy and safe to implement, and will raise a lot of money every year.

We know how to implement the CTT, and we can do it right away.

The CTT is a proportional, or percentage, tax on individual foreign exchange transactions, assessed on dealers in the foreign exchange market and collected by financial clearing or settlement systems. Foreign exchange dealers are financial institutions that display bid or buy and ask or sell exchange rates, that trade currencies on demand at those or better rates, and that have direct access to large-scale financial settlement systems. Dealers trade currencies with other dealers or with non-dealer customers.

The CTT can be collected by the existing global financial settlement systems, such as the Continuous Linked Settlement (CLS) Bank or SWIFT. It can be collected on all foreign exchange instruments no matter where or how they are traded. With these modern, centralized settlement systems, it is impossible to avoid the CTT on a large scale. They already collect transaction settlement fees automatically, so it would be easy to have them collect the CTT as well. They can do this for individual currencies or for multiple currencies at once.

The CTT will not disrupt foreign exchange markets.

A CTT in foreign exchange markets would immediately widen bid-ask spreads, which are the gaps between buying and selling exchange rates offered by dealers. Bid-ask spreads fluctuate all the time, so, of itself, this is not a problem. It is a problem if the tax rate is set too high, so spreads widen too much and the number of foreign exchange transactions would falls too far. Then the markets would no longer be efficient and the behavior of exchange rates would change.

The desired CTT rate raises lots of money without disrupting the foreign exchange market. There is no way to identify that rate precisely. Practically, however, post-tax spreads should be well within the range of recent spread values and transaction volumes should not fall much.

A CTT of 0.5 basis points, or 0.005 percent, on every foreign exchange transaction in dealer markets, would widen spreads at most by one basis point. Spreads in the major currency markets, for the dollar, euro, yen, and sterling, commonly fluctuate by up to a basis point and, less commonly, by more. They also increase persistently, by a basis point or more. So, a permanent increase in spreads of one basis point, due to a CTT of 0.5 basis points, would conform to recent experience.

We estimated by econometric regression the relationship between spreads and the number of transactions in the dollar/yen market. We discovered that a CTT of 0.5 basis points would reduce transaction volumes by 14 percent. Volumes in the dollar markets have fallen by nearly that amount in the past, without any noticeable impact on exchange rate behavior. If a CTT were implemented today, foreign exchange markets would still be larger than they have ever been in the past.

By these comparisons, it is unlikely that a CTT of 0.5 basis points would disrupt either exchange rate behavior or market liquidity.

The CTT will raise lots of money for development.

We estimate that a CTT of 0.5 basis points on the major currencies would yield an annual revenue of at least US$ 33 billion. It is likely to be much more than that, since we consider only the traditional spot, outright forward, and swap derivative markets. The non-traditional markets are larger, but it's also harder to predict CTT revenues from them.

A CTT of 0.5 basis points levied only on the dollar, against all other currencies, would yield an annual revenue of US$ 28 billion. This is only US$ 5 billion less than a tax on all the major currencies, since most foreign exchange transactions involve the dollar. A CTT on all the major currencies except the dollar would yield revenue of US$ 21 billion. A CTT on the euro alone would yield US$ 12 billion; on the yen alone, US$ 6 billion; and on sterling alone, US$ 5 billion.

CTT revenues compared to revenues from other new sources

There are other potential new sources of financing for development. They are not all comparable to the CTT. The International Finance Facility and International Finance Facility for Immunisation do not raise new revenues, but bring forward normal flows of official development assistance so they will peak between 2010 and 2015. Barring changes in policy, ODA would fall commensurately below normal levels after 2020. An issuance of Special Drawing Rights by the IMF for development would likely occur only once.

Some of the new revenue sources, such as the air ticket levy and the IFFIm, are underway, the former as a pilot project in France, the latter as a specialized version of the IFF-proper. We may have more confidence in these revenue estimates than in the others, which are necessarily speculative. At US$ 200 million and US$ 4 billion, respectively, they are at the low end of the new revenue generators, but will bring in much more as other governments join the schemes. The carbon tax has by far the greatest potential to raise revenue, estimated at between US$ 130 and 750 billion each year, depending on the tax rate. However, it is also intended to discourage carbon emissions, so the tax base will fall over time and a large share of the revenue may go to the affected industries and employees.

Advantages of the Currency Transaction Tax

The CTT is a feasible new source of revenue for development and other global projects. It is safe and easy to implement, and can immediately raise at least US$ 33 billion of global, independent, and stable revenue each year. The CTT therefore appears to be