



# Responses to Criticisms of Taxes on Financial Speculation

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## About the Author

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## Introduction

Although the national debate on financial transactions taxes (FTT) has just begun, there have been a wide range of responses arguing that the tax is either undesirable or unenforceable, or both. This discussion presents a brief response to these criticisms.

Arguments against the desirability of an FTT:

- 1) It will increase the volatility of stock and other asset prices
- 2) It will reduce the liquidity of financial markets
- 3) It will reduce the efficiency of financial markets
- 4) The costs will be born by middle class investors, not short-term speculators

Arguments against the enforceability of an FTT:

- 1) Trading volume will be sharply curtailed in response to an FTT, therefore there will be little revenue collected
- 2) Trading will be shifted from assets where the tax is applied to assets where the tax does not apply
- 3) Trading will migrate to tax havens, such as the Cayman Islands.

These objections are discussed below.

## The Desirability of an FTT

### Volatility of Asset Prices

While critics have argued that FTTs will raise volatility, the evidence on the relationship between volatility and transactions taxes is actually quite mixed.<sup>1</sup> An FTT will raise transactions costs and therefore reduce the volume of trading. This is one of the main purposes of the tax.

Some of transactions that will be discouraged by an FTT will be stabilizing. For example, arbitrageurs trade to take advantage of small differences in prices between different markets. Insofar as arbitrageurs reduce their trading as a result of the tax, there can be somewhat larger gaps in prices between markets that go uncorrected. This can lead to more volatility in prices.

However, higher volume trading can also be destabilizing. If traders act, not on their own judgment, but rather in response to the trades of others, then more trading can amplify fluctuations away from fundamental values. In this case, an FTT can be expected to reduce volatility.

Efforts to measure the impact of FTTs, transactions, and trading volume on volatility have produced mixed results. Several studies have found that higher transactions costs are associated with

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<sup>1</sup> See Pollin, Baker, and Schaberg (2002) for a fuller discussion of the issues addressed in this paper.

higher volatility (e.g. Jones and Seguin [1997]). However, other studies have found no significant relationship between volatility and transactions taxes (Hu [1998] and Hau and Chevallier [2000]). In an interesting study, Roll (1989) found that markets with transactions taxes had no greater volatility in the period around the 1987 stock market crash than markets without a tax. Lindgren (1994) found that high transactions taxes increased volatility, however smaller transactions taxes (less than 0.5 percent) had no significant effect on volatility.

In fact, one notable study (French and Roll [1986]) found evidence that more trading does increase volatility by comparing the volatility of the New York Stock Exchange over three-day periods where the market was open every day with three-day periods in 1968 that included a Wednesday where the NYSE was shut to deal with paperwork. Volatility was considerably higher in the former set of days than the latter, suggesting that trading, rather than events in the world, was leading to market fluctuations. This study concluded that at least a portion of this volatility was due to noise trading, where traders responded to market momentum or other noise rather than making an independent assessment of market fundamentals. If this noise trading is discouraged by higher transactions costs, then an FTT would reduce volatility.

It is possible that an FTT can both increase some types of volatility and reduce others. Specifically, it may lead to a situation in which somewhat larger divergences from fundamentals may go uncorrected. However, it may also lead to situations that are less prone to the sort of speculative run-ups that we have seen in markets in recent years. The latter would be difficult to test, since unambiguous examples of speculative price movements are relatively rare.

Finally, it is important to remember that the tax rates currently being considered are relatively modest. Trading costs have fallen sharply over the last three decades due to improvements in computer technology. Therefore, even with FTTs in place, transaction costs would only be rising to their level of two decades ago in most markets. Insofar as high transactions costs actually do increase volatility, the set of FTTs being considered would only raise levels of volatility back to their 1980s level.

## Market Liquidity

Critics of FTTs have argued that they will reduce the levels of liquidity in financial markets, which could make it more difficult for investors to sell assets. There is some truth in this claim, but it is likely to be of very little consequence in almost all cases.

An FTT will raise transactions costs and therefore reduce trading volumes. This means that markets will be somewhat less liquid (i.e. people may have to wait longer before they can sell shares of stock or bonds). However, it is important to recognize that since transactions costs will just be driven up to their 80s level, there is no reason to believe that markets will be any less liquid than they were in the 80s. Of course, the United States and other wealthy countries already had vibrant capital markets in the 80s, so it would be difficult to argue that the lower levels of liquidity would impose any major hardship on ordinary investors.

It is also worth noting that tax will have a smaller impact on less liquid assets than on highly liquid assets for the simple reason that less liquid assets already have higher transactions costs. The transactions costs for trading the stock of small companies listed on the NASDAQ can be several

times larger than the cost of trading the stock of large companies. This means that adding a fixed amount to the transaction cost through a tax (e.g. 0.25 percent) will impose a much smaller percentage increase in the transaction costs for a less often traded stock, therefore it should have less impact on its liquidity. This means that the greatest reduction in trading volume will occur in assets that have the most liquid markets, leaving them still quite liquid. The impact of the tax on trading volumes in markets that are already not very liquid will be considerably smaller.

## **Market Efficiency**

Critics of FTTs have also argued that they will reduce the efficiency of financial markets. This means that they may be slower in responding to changes in market fundamentals. Insofar as markets are less efficient, this could mean, for example, that the price of oil stocks will rise less rapidly in response to news of a disruption in supplies from a major producer. Baltagi et al. (2006) have found some evidence for this sort of reduction in efficiency.

While lower trading volume could in fact lead to less efficiency (it can also lead to more efficient markets if it reduces noise trading), it is important to realize the limited impact of this effect. Again, since trading costs would just be pushed up to their 1980s level, markets will be no less efficient than they were in the 80s. As a practical matter, the issue is likely to be a question (using the oil stock example) of whether prices adjust in a single day or over a couple of days. It is difficult to imagine that this sort of delay in price adjustment would have any major repercussions for investment and real economic activity.

## **Middle Class Investors Will Bear the Burden of the Tax**

Most middle class investors trade their portfolio relatively infrequently. Their goal is to save for specific purposes such as retirement or their children's education, not make a fortune by constantly flipping stock or other assets. This means that their investment returns would be little affected by a modest tax.

Furthermore, the bills that have been introduced in both the House and the Senate provide exemptions for nearly all the transactions that middle class investors are likely to undertake. Trades by 401(k)s and other tax-sheltered accounts would be exempted from the tax as would trades by pension funds. In addition, there would be a large exemption for each individual, making it unlikely that middle class investors will pay the tax.

Hedge funds and other large traders will pay the tax, but they are likely to respond to the tax by cutting back substantially on the frequency of their trades. As a result, their total trading cost may be little affected, even if the tax does cause them to incur much higher transactions costs on each trade. This means that even these large traders may see little net increase in the total cost of their financial transactions.

## The Enforceability of an FTT

### Plunging Trading Volume Means that Little Revenue Will Be Collected

It is argued that trading volume will be sharply reduced in response to the tax; therefore the government will collect little revenue. In fact, the calculations of the revenue raised through a tax assume sharp reductions in trading volume. Current levels of trading are so large that even a 50 percent reduction in volume would still lead to a very substantial amount of revenue being collected. A calculation based on 2008 trading volumes showed a broadly based tax collecting more than \$170 billion a year, assuming that trading volume falls by 50 percent.

If the resources (e.g. labor and capital) tied up in trading are cut back, without damaging the financial sector's ability to service the productive economy, then this is a net gain to the economy. It would mean eliminating waste in the sector, thereby making the economy run more efficiently. In other words, if the tax led to a cutback in the money spent on trades of \$100 billion a year, this would present the same benefit to the economy if we cut our trucking or energy costs by \$100 billion a year. This is an important benefit that could result from the tax, not a negative consequence to be feared.

### Speculators Will Move to Untaxed Assets to Avoid the Tax

Traders will absolutely try to switch from assets where the trades are taxed to assets where they are not taxed. This is why the tax is constructed to cover the whole array of tradable assets. The rates are varied to be appropriate for different types of assets, but in principle no asset should escape taxation. It is worth noting that the U.K. raises the equivalent (relative to its GDP) of more than \$30 billion a year on a tax that is only applied to stock trades, not the full range of assets covered by the bills proposed in the House and Senate

### Speculators Will Move Their Trades to Other Countries to Avoid the Tax

It is argued that traders will seek havens where the tax does not apply. While there will be some efforts to shift the location of trading to evade the tax, it is likely that the impact of such shifting on the revenue collected will be relatively limited.

First, there are many reasons why traders would opt for the security of the major exchanges in the United States as opposed to operations in the Cayman Islands or some other tax outpost. There are already large differences in transactions costs between countries, yet all trading does not flee to the lowest cost country. As noted above, the UK collects the equivalent of more than \$30 billion annually on a tax that only applies to domestic stock trades and trades of UK-based companies on exchanges in other countries.

The second reason why the amount of trade shifting to evade taxation will be limited is that the leadership of most other wealthy countries, including France, Germany, and the United Kingdom, has expressed interest in their own financial transactions taxes. There seems little doubt that if the United States pushed for such taxes at the G-20 or other international forums that it could count on considerable cooperation from other countries.

The problem posed by tax haven countries, like the Cayman Islands and Lichtenstein, is fundamentally misrepresented in public debate. The issue in dealing with the tax haven status of these questions is purely a question of political will. If the United States and other wealthy countries sought to cut off tax haven countries from access to the international banking system, they would quickly lose their usefulness as tax havens. If the Cayman Islands were running guns for Al Qaeda, the United States would find a way to stop it. The fact that it remains a tax haven is because the political leadership in the United States and other wealthy countries opt to allow it to operate as a tax haven.

Finally, it is worth noting that the bill in the Senate would apply to all trades by U.S. corporations or U.S. nationals, regardless of where they take place. This would mean that any trades taking place in Lichtenstein, the Cayman Islands, or anywhere else would be legally subject to the tax. While traders may lie about such transactions to avoid paying the tax, they would be taking large risks if they were caught. Also their employees who actually carry through the trades can be given substantial incentives to report violations. For example, they can be given 10 percent of any tax revenue collected as a result of reporting violations. There are undoubtedly many lower level employees in the financial industry who would relish the opportunity to get wealthy by reporting their boss.

As a basic principle it is worth noting that enforcing a financial transactions tax should be far simpler than enforcing other rules whose value is rarely questioned. Copyrights would be an obvious example of such a rule. In the case of copyright enforcement, the government must be prepared to police the actions of billions of potential infringers around the world, each of whom is only committing a trivial infraction. By comparison, effective enforcement of financial transactions taxes requires only the policing of a relatively small number of very large transactions.

While copyright infringement is widespread, the fact remains that companies like Microsoft, Time-Warner, and Disney are still able to earn tens of billions in profits each year based on their copyrights. If copyrights can be enforced to the point that copyright-dependent companies can remain highly profitable, then there is little reason to doubt that U.S. government could in principle maintain a sufficient level of enforcement that it can raise large amounts of revenue through a financial transactions tax.

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