

Don't Enact Financial Transaction Taxes

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It's an idea that some policymakers might find tempting: raising billions for U.S. government coffers by taxing financial transactions such as stock, bond, and derivatives trades. The temptation is heightened as proponents of the tax assure us that it will also produce a range of positives, such as curbing speculation, all at minimal cost.

Don't fall for it. Dubious to begin with, any benefits of a financial transaction tax (FTT) would be dwarfed by the harm it would inflict on America's savers, particularly its 90 million mutual fund shareholders.

FTT supporters cast the tax as a small burden, pointing to the tax's low rate. Overseas, for example, the recently enacted French FTT imposes a levy of 20 basis points (0.2 percent) on trades of stocks issued by French companies with a market capitalization of €1 billion or more. Over the strong objections of other member states such as Sweden and the United Kingdom, the European Commission appears to be moving forward with an 11-country plan to impose a unified FTT scheme, charging 10 basis points for stocks and bonds, and 1 basis point for derivatives.

Some U.S. commentators have spoken admiringly of these schemes. But were the U.S. government to move ahead with an FTT, the implications for American investors would be anything but small. In the fund business, portfolio managers must transact every day—they routinely trade their portfolio securities as they invest shareholder cash, meet shareholder redemptions, and adjust their holdings. Levying an FTT will raise transaction costs on all trades, which will produce a constant drag on shareholder returns. Diminished returns make it all the harder for fund investors to achieve retirement security and other goals.

Moreover, FTTs can add double, even quadruple, levels of investor taxation. A fund investor would face being taxed when purchasing shares of a fund, taxed again as the fund puts the investor's money to work in the market, taxed yet again if the fund sells portfolio holdings to meet the investor's redemption request, and taxed a fourth time when redeeming the fund shares themselves.

Let's take another argument put forward by FTT supporters: that the tax will tamp down speculative, computer-driven trading and financial engineering. For the latter, the more likely outcome is just the opposite. The French experience is instructive. In the short time since France enacted its FTT, trades in covered stocks are reported to have declined by 10–15 percent while trades in non-covered derivative products have spiked by 20–25 percent. Indeed, the French seem to agree on only one fact about the new tax—large players are able to skirt the tax using an array of techniques, leaving small investors to bear the burden.

As for fixing any problems arising from automated trading and so-called “high frequency trading,” the FTT, with its broad impact on all investors, seems an awfully blunt tool for achieving that goal. Thankfully, regulators are already examining a range of more targeted policy steps to address concerns in this area.

What about engineering the FTT itself to mitigate its effects? Proponents of these taxes have tried to do so—for example, by proposing exemptions based on income levels or dollar amounts of transactions. Such fixes have their own problems, which become clear on closer examination. For one, they don't go far enough. Policymakers couldn't simply exempt purchases and redemptions of fund shares. They'd also have to figure out a way to compensate investors from their share of any tax imposed on the fund's portfolio transactions. Setting up a mechanism like this, such as through a tax refund, would likely be highly difficult costly to develop and administer.

Heavy costs for savers, new financial complexity, new administrative burden—to these FTT negatives, we can add another: a historical track record of failure. Consider Sweden, which adopted an FTT in 1984. After the country doubled its transaction tax rate in 1986, half of all trading in Swedish equities migrated outside the country. Meanwhile, stock price volatility on Swedish markets

showed no change after the tax was imposed. Sweden got rid of it in 1991.

The Swedish experience and emerging French evidence suggest a better approach to FTTs: don't enact them.

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