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A Transaction Tax Would Hurt All Investors

The unintended consequences of the 'Let Wall Street Pay for the Restoration of Main Street Act.

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'Don't tax you, don't tax me, tax that fellow behind the tree." Those famous words were spoken more than 30 years ago by the late Louisiana Sen. Russel B. Long when Congress was looking for ways to raise revenue. Some members of Congress believe they've found the fellow behind the tree: the Wall Street "speculator."

Wall Street is widely blamed for causing the current economic mess, so why not let them pay for it? The idea is to impose a 0.25% tax on the value of stock transactions, and on a variety of derivative transactions. Indeed, the bill introduced last week in the House by Rep. Peter DeFazio (D., Ore.) and others is called the "Let Wall Street Pay for the Restoration of Main Street Act." Sen. Tom Harkin (D., Iowa) plans to introduce a companion bill in the Senate. Proponents believe the legislation could raise $150 billion per year.

A small increase in trading costs would, according to supporters, be a manageable burden, and one borne by the speculators who the bill's authors apparently believe (to judge by the bill's name) created the financial mess. Across the pond, Prime Minister Gordon Brown of Britain has supported the idea as a way to take the burden off taxpayers during a time of financial crisis. In reality, the tax would deal a poorly-timed blow to long-term investors everywhere.

Proponents of a transactions tax misunderstand the way markets work. The bubble in home prices in the United States was not caused by the rapid buying and selling of individual family homes. The financial crisis was primarily a liquidity crisis and a credit crunch, and the major problem with collateralized mortgage-backed bonds was that they declined significantly in value and became illiquid. A transactions tax that would have reduced trading and made repurchase agreements more costly, could have made the problem even worse.

Moreover, "Wall Street" would not foot the bill for the presumed $150 billion tax. In fact, the tax would simply be added to the cost of doing business, burdening all investors, including 401(k) plans, IRAs and mutual funds.

Some argue that high-frequency traders, who reportedly execute 70% of the equity market trades, would pick up the lion's share of the bill. But high-frequency traders are not villains—indeed, they play an important role in improving market efficiency.

Often mischaracterized as speculators, high-frequency traders scour markets for minor mispricings and arbitrage trading opportunities. They buy and sell stocks in an instant, hoping to earn pennies on a trade. Far from destabilizing or creating volatility in the market, their actions significantly increase trading volume, reduce spreads, promote price-discovery,

and ultimately reduce transactions costs for long-term investors. Such trades might not be doing God's work, but they are socially useful.

Transactions costs have declined significantly over the past 10 years, thanks to the many structural changes in equity markets, including trading in decimals instead of eighths, the proliferation of scores of trading venues that function as exchanges, and an explosion of high-frequency trading. Vanguard has estimated that total transactions costs on an average trade have fallen by more than 50%, resulting in approximately $1 billion of annual savings to its investors. When magnified across the whole investment industry, investors have probably saved tens of billions of dollars in transactions costs.

Transactions taxes would make most current high-frequency trades unprofitable since they depend on the thinnest of profit margins. Trading volume would collapse, and there would be a dramatic shortfall in the tax dollars actually collected by the government. Market liquidity would decline, bid-offer spreads would widen, and all investors would pay significantly higher costs on their trades.

A tax on financial transactions would have to be imposed internationally to prevent any particular national market from being disadvantaged. It would be very difficult to achieve universal international consensus regarding the details of such a tax. In our environment of global capital markets, it would be virtually impossible to enforce it reliably.

The U.S. has the broadest, deepest, most liquid and efficient capital markets in the world. This is why it can continue as the world's premier reserve currency nation despite consistent trade deficits. People are attracted to the our financial markets because of their high liquidity and low transactions costs. Efficient capital markets also benefit all individual investors who save and invest through 401(k)s, IRAs and other retirement programs. The transactions tax would gravely wound financial markets. It is hard to imagine a piece of legislation that would have more damaging unintended consequences.

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