

Wharton Financial Institutions Center
University of Pennsylvania
2444 Steinberg Hall - Dietrich Hall
3620 Locust Walk
Philadelphia, Pennsylvania 19104-6367
1. 215. 898. 5613 (tel)
1. 215. 898. 1279 (fax)
herring@wharton.upenn.edu

Richard J. Herring
Executive Director
University of Pennsylvania

Steering committee

Jennifer Conrad
University of North Carolina – Chapel Hill

Robert Eisenbeis*
Cumberland Advisors

Richard J. Herring*
University of Pennsylvania

George G. Kaufman*
Loyola University, Chicago

Maureen O'Hara
Cornell University

Rafael Repullo
CEMFI

Jay Ritter
University of Florida

Stephen Schaefer
London Business School

Seymour Smidt
Cornell University

Statement on

Taxes on Financial Transactions

The Financial Economist Roundtable (FER) is a group of senior financial economists who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decisions.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among at least two-thirds of the attending members and is signed by all the members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media. This statement is the outcome of the FER's discussion at its annual meeting that took place on July 20-22, 2013 in Napa Valley.

The statement examines the various motives for implementing a financial transaction tax based on analysis of recent proposals advanced in the United States and the European Union. The statement concludes that although such taxes have superficial appeal, they have large negative consequences relative to the revenue they may be realistically expected to raise. Moreover, the dangers of damaging capital allocation mechanisms and of harming investors in publicly-traded securities are significant. A financial transactions tax would distort markets, reduce liquidity, lower securities prices, and increase the cost of capital throughout the economy. Proponents of financial transactions taxes assume that such taxes would be borne by the financial services industry, but although the industry would collect taxes on transactions that are not shifted to the more opaque over-the-counter markets in attempt to avoid such taxes, the burden would fall primarily on the customers of financial institutions through lower prices and wider spreads between purchase and sales prices. In the short run the financial sector would be penalized, but in the long run the lower prices of financial securities caused by a financial transactions tax would result in lower capital per worker and thus lower wages.

For additional information contact:

Larry Harris
Marshall School of Business
University of Southern California
213-740-6496
LHarris@usc.edu

Jay Ritter
Warrington College
of Business Administration
University of Florida
352- 846-2837
jay.ritter@warrington.ufl.edu

Stephen Schaefer
London Business School
44 (0)20 7000 8267
sschaefer@london.edu

Statement of the Financial Economics Roundtable

Financial Transaction Taxes

Proposals to tax financial transactions are now popular. Eleven European Union countries recently agreed in principle to implement such a tax in January 2014, and bills to tax financial transactions are introduced regularly in the U.S. Congress. Senator Tom Harkin and Congressman Peter DeFazio introduced the latest such bill, the “Wall Street Trading and Speculators Tax Act,” on February 28, 2013.

Many concerns motivate these proposed taxes. Some want the financial sector to pay for the tremendous economic costs that they believe it imposed on everyone in the Global Financial Crisis of 2008. Others believe that the financial sector should bear its “fair share” of taxes. Such beliefs are particularly strong in countries where financial transactions are exempt from value-added taxes and therefore “escape” taxation. Still others simply want new revenues to support additional government spending, reduce the deficit, or provide tax relief to other sectors. Finally, some commentators believe that too much financial activity focuses on short-term rather than long-term goals. They believe that a transactions tax would force investors and businesses to focus more on long-term values and not on short-term activities that they perceive to be wasteful.

Although many members of the Financial Economists Roundtable recognize and respect these concerns, the signatories believe that governments should be extremely wary of adding or increasing transactions taxes on financial transactions. We are of the opinion that financial transactions taxes have large negative consequences relative to the revenue raised. The dangers of damaging capital allocation mechanisms and of hurting investors in publicly traded securities are large.

Benefits from Financial Transactions

Financial transactions serve many important purposes in market-based economies:

- Investors use financial transactions to save money for future uses. Public, private, and personal retirement savings constitute the largest such uses.
- Household borrowers use financial transactions to pay for large current expenditures. Financing home purchases and the tuition costs of education are two very important such uses.
- Companies use financial transactions to fund new projects, many of which generate new jobs and produce new beneficial products.
- Producers use financial transactions to hedge risks associated with promising, but risky projects.
- Governments use financial transactions to raise money for infrastructure investment and social programs.

New or higher taxes on financial transactions would make these transactions more expensive, and so reduce their volume. Some investors would invest less and spend more now. Some borrowers would forgo current expenditures that would otherwise make them better off. Some companies would not invest in desirable new projects. Some hedgers would not undertake promising risky projects that would otherwise benefit the economy. Losing these transactions would hurt both the broad economy and the many individuals who use or depend upon well-functioning capital markets.

Taxing Financial Transactions Is Costly

Taxes on financial transactions make financial markets less liquid by imposing additional costs on traders and on the dealers who allow investors and companies to trade when they want to trade. Faced with higher transaction costs, stocks and bonds would be less valuable to investors. Asset values would be lower and the cost of capital higher.

The effect that a tax on equity trading would have on the market for new equity issues particularly concerns us. Investors are willing to buy new issues in part because they value the opportunity to sell them at any point in the future: Investors know that they may need cash earlier than expected or that they may lose confidence in the issuer. Well-functioning equity markets make buying new securities more attractive because they assure investors that they generally can sell their investments at low cost when they no longer want to hold them.

A financial transactions tax that exempts new issues, as is sometimes proposed, would still adversely affect the new issue market with the following chain of effects on the economy:

- A transaction tax would make equity markets less liquid.
- Both the anticipated lower liquidity and the taxes that would be paid by current and future owners of a security would make new equity issues less attractive to investors and thus lower their prices.
- The lower new issue prices would result in higher costs of capital to companies.
- Some otherwise good investment projects would not be undertaken, resulting in a less productive economy and ultimately lower wages because there would be less capital per worker.

Financial Transactions Are Different

The central role of financial transactions within market economies makes financial transactions different from transactions in other goods and services. Unlike taxing trades in most goods and services, for which the effects are usually direct and obvious, the taxation of financial transactions would produce many negative effects that extend far beyond the financial markets. A tax on financial transactions would generate indirect effects that impose costs throughout the economy.

Unintended Consequences

The introduction of a financial transaction tax would have many unintended consequences:

- Despite the best efforts of those framing the tax rules, trading would shift to markets and countries where the taxes are not imposed. The proposed adoption of transaction taxes by the 11

European countries would undoubtedly shift much trading to London, Hong Kong, New York, and a variety of tax havens, benefiting other countries that do not collect these taxes.

The Swedish experience with financial transaction taxes in 1984-1991 is particularly instructive: Following the imposition of various taxes on equity trades, options trades, and fixed income trades, a large proportion of trading moved out of the country—primarily to London—and Sweden collected far less tax revenue than expected.

Equally instructive is the tremendous growth in the Eurobond market following the adoption in 1963 of the US Interest Equalization Tax. This transaction tax on foreign stocks and debt obligations effectively ended trading in these securities in the United States and transferred a large fraction of the market to London.

- Convoluted financial structures would develop as financial intermediaries design products and procedures to avoid transaction taxes. For example, a fund might invest in an unconsolidated special purpose entity domiciled outside the tax jurisdiction to avoid transaction taxes. This entity then could trade securities outside the tax jurisdiction, and thereby avoid the transaction tax.
- Because proposals to tax transactions generally exclude bank loans and time deposits, commercial banks would become increasingly important in the financial sector. This result should give pause to those who seek transaction taxes to penalize the financial sector for the excesses that led up to the Global Financial Crisis, since much of the alleged bad behavior occurred in commercial banks.
- Large distortions would occur if the tax rates were set so that the tax payment on a derivative contract trade would differ from the tax payment on a trade representing the equivalent amount of risk exposure in the underlying instrument (as the 11 European countries currently propose). Such differences would cause traders to shift trading from the high tax vehicle to the low tax vehicle. For example, the derivative contract-for-differences market in the UK exists in large part to allow traders to avoid the UK stamp tax.

These substitutions would not take place if the tax rates for equivalent risk exposures were all equal. However, equalizing these rates would require very complex rate schedules for derivative securities, such as options, for which the relation between the security value and the underlying risk is nonlinear.

- Large distortions also would occur if the tax rates were set to reflect the average holding periods of similar financial instruments. If a flat tax were applied to all instruments, short-term contracts like daily repos would become much less attractive than longer term contracts, such as term loans, since repo traders would pay the transaction taxes everyday whereas traders in longer-term contracts would pay them much less often. For example, a one basis point tax on a daily repo would be the equivalent of 2.52% annual tax because repo traders would have pay the tax on each of the 252 business days in a year. This rate, which is higher than current interest rates, would effectively stop trading in the repo market. A transaction tax thus has the potential to have a major – and we suspect unintended – effect on the funding of the financial system.

These distortions would not take place if the tax rates were set to equalize the rate of tax collection over time. However, equalizing these rates over time would be impossible for contracts, such as options, for which the contract termination dates are not certain. The application of too high a rate on these contracts

would cause traders to avoid using options. Too low a rate would cause traders to shift into options to avoid the tax.

- Attempts by practitioners to avoid financial transaction taxes and corresponding attempts by taxing authorities to secure financial transaction tax revenues would complicate the financial system. Financial risk managers trained in systems engineering recognize that complexity is an important cause of systemic risk. The additional complexity associated with new taxation systems and the inevitable efforts to avoid those taxes would work against efforts to reduce systemic risk.

Misplaced Concerns

Proponents of financial transaction taxes expect that the tax would be borne by the financial services industry. In fact, although the industry would collect the tax, the burden would fall primarily on its customers through higher fees and wider spreads between purchase and sales prices. Repeated experience has shown that the ultimate bearers of a tax are always those least capable of avoiding it. The financial services industry would hurt a little because the tax would decrease total trading volumes, but its customers would hurt much more because they are the ones who ultimately must trade to invest, borrow, and hedge.

Concerns about excessive speculation and excessive volatility also motivate arguments in favor of financial transactions taxes. However, empirical evidence generally does not support this premise. Consider for example real estate markets, in which transaction costs and taxes are very high and make trading very expensive. If high transactions costs discouraged speculation, bubbles in real estate markets would be rare. Regrettably, as events in the real estate markets in the US, Ireland, Spain, the UK, and elsewhere showed all too clearly in the years leading up to the Global Financial Crisis of 2008, they are not.

Some commenters advocate a financial transaction tax to address problems that are perceived with high frequency trading (HFT). A transaction tax would reduce HFT along with all other forms of trading. However, it would not end the practice. Nor would it address the most serious problems associated with HFT that involve various predatory strategies such as front-running, which generally depend more on trading speed than on trading frequency. Moreover, dealing and arbitrage strategies are the most common and important HFT trading strategies. These strategies benefit investors and hedgers by making markets more liquid. Policies that hurt HFT traders employing these strategies would hurt all traders, including long-term investors.

Finally, a financial transaction tax is attractive to some proponents who are concerned about excessive focus on short-term as opposed to long-term results. While we are sympathetic to those concerns, we also note that many investment and borrowing problems are by their nature short-term problems. Examples are:

- Operating companies, banks, mutual funds, and governments rarely have perfectly synchronized cash inflows and outflows. Instead, they regularly must invest their surpluses and finance their shortfalls. The generally short time horizons associated with these cash management transactions make them particularly exposed to even small transaction taxes. The introduction of a transaction tax would greatly complicate attempts to manage cash outside of the banking system.

- Many short-term transactions occur because investors, borrowers, and companies rationally delay making long-term commitments until they are sure that they have adequately explored all available options. Taxing short-term transactions would cause some important decisions to be made too early, which would result in wasted resources and opportunities.

Many governments already favor long-term investing over short-term investing by setting lower tax rates on long-term capital gains or on dividends paid to long-term stockholders. Using a transaction tax to further incent long-term transactions is unwise given the inefficiencies that it would produce.

Other Problems with Transaction Taxes

Since capital flows are very sensitive to differences in costs, a financial transaction tax would not collect anywhere near the revenues that a simple application of the tax rate to existing volumes would suggest. Instead, volumes—and thus tax revenues—would shrink as trading drops or moves to other locations or less taxed vehicles.

Financial transactions taxes are inferior taxes because they do not produce reliable revenue streams. Trading volumes vary substantially from year to year, and consequently revenues would vary as well.

Any transaction tax must tax trades arranged at exchanges and off exchanges at the same rates, otherwise trading would migrate to the less taxed venue. However, collecting taxes on over-the-counter (OTC) trades is much more difficult than collecting taxes at exchanges because of the inevitable tax compliance problems associated with trades that are not all reported to a third party. These problems would be particularly acute if the taxable trades take place outside of the jurisdiction attempting to collect the taxes. The ability to avoid taxes by trading OTC—whether legal or not—would lead to an increase in less transparent OTC trading and a reduction in tax revenues.

Finally, we fear that a tax imposed by some countries on transactions occurring in other countries would lead to tax conflicts among countries, which can be politically troublesome and thus costly. But without such extraterritorial provisions, attempts to collect financial transactions taxes would prove to be futile and costly to the taxing countries.

Conclusion

Not all taxes are economically sensible, regardless of how desirable they may appear. A transaction tax imposed at any economically meaningful rate by only some countries would result in many transactions being shifted to other countries, resulting in far less revenue raised than a simple static analysis would suggest. Furthermore, to the degree that a financial transaction tax does generate substantial revenue, the tax and the associated reduction in liquidity would lower asset prices. Lower asset prices would cause decreased corporate investment, resulting in less capital per worker in the long run and therefore lower wages throughout the economy. Governments thus should be extremely wary of adding or increasing transactions taxes on financial transactions.

FER Members Signing the Statement, “Financial Transaction Taxes”

Rashad Abdel-Khalik

University of Illinois at Urbana-Champaign

Edward I. Altman

New York University

Harold Bierman

Cornell University

Marshall E. Blume

University of Pennsylvania

Arnoud Boot

University of Amsterdam

Charles W. Calomiris

Columbia University

Jennifer Conrad

University of North Carolina

Tom Copeland

University of San Diego

Elroy Dimson

London Business School

Darrell Duffie

Stanford University

Franklin R. Edwards

Columbia University

Robert A. Eisenbeis

Cumberland Advisors

Charles A. E. Goodhart

London School of Economics

Larry Harris

University of Southern California

Richard J. Herring

University of Pennsylvania

Thomas Ho

Thomas Ho & Company

Takeo Hoshi

University of California, San Diego

Ravi Jagannathan

Northwestern University

Kose John

New York University

Charles Kahn

University of Illinois at Urbana-Champaign

Edward J. Kane

Boston College

Jon Karpoff

University of Washington

Anil Kashyap

University of Chicago

George G. Kaufman

Loyola University

Jan Pieter Krahen

Johan Goethe University

Dennis E. Logue

Ledyard National Bank

Robert McDonald

Northwestern University

Maureen O'Hara

Cornell University

Rafael Repullo

CEMFI

Jay R. Ritter

University of Florida

Stephen Schaefer

London Business School

Kenneth E. Scott

Stanford Law School

Lemma W. Senbet

University of Maryland

Jeremy Siegel

University of Pennsylvania

Chester S. Spatt

Carnegie Mellon University

Robert F. Stambaugh

University of Pennsylvania

Laura T. Starks

University of Texas at Austin

Hans R. Stoll

Vanderbilt University

Ingo Walter

New York University

Roman L. Weil

University of Chicago

Ingrid Werner

Ohio State University