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Financial Transaction Tax: Taxing U.S. Investment, Savings, and Growth

"Financial Transaction Tax: Taxing U.S. Investment, Savings, and Growth" Center for Capital Markets Competitiveness U.S. Chamber of Commerce

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Thank you, David [Hirschman], and thank you to the Chamber for sponsoring this event. There's been a lot of populist rhetoric around this idea of "making Wall Street pay," and it's vital that we educate the public on the issue. The Chamber is doing a great service by hosting this discussion.

In my brief time, I want to make four points. I will address the DeFazio-Harkin legislation, H.R. 4191, but for the most part these points would apply to securities transaction taxes generally.

- First, more and more middle-class Americans are investors who count on securities markets to help them meet their goals for retirement, education, and other needs.
- Second, it's easy to pretend that you can exempt Main Street investors from a transaction tax. But in reality, it's almost impossible to do so, and incredibly expensive even to try.
- Thirdly, the creativity of America's financial engineers is almost unbounded—and they will view any transaction tax as a challenge, not as a barrier.
- Given those points, my conclusion is that sophisticated investors, traders, and hedge funds will find ways to escape it. And the people who will pay are the little guys. So this effort to punish Wall Street

is going to damage Main Street instead.

America's financial landscape has changed enormously since the 1960s, when the U.S. last had a large-scale, high-rate tax on securities transactions. Federal Reserve household survey data show that since 1962, the percentage of American households who owned stocks has more than doubled. In 2008, about half of all American households owned stocks, including most of the 50 million workers who are actively saving for retirement through 401(k) plans. For many households, stocks are held indirectly through mutual funds. Since 1960, assets in mutual funds that hold equities have grown from $16 billion to more than $5 trillion. At ICI, we calculate that up to 79 million shareholders of long-term mutual funds could be subject to the DeFazio-Harkin tax—and they are certainly not all hedge fund managers, speculators, or high-frequency traders.

Now, the sponsors of H.R. 4191 maintain that they have protected the "little guy" from the tax. And they have written into their bill various exemptions for purchases and sales of mutual fund shares, for pensions and retirement accounts, and for trading activity of less than $100,000 a year. Unfortunately, those exemptions will not work, at least not for mutual fund investors.

First, while the bill exempts investors' trading in fund shares, it still taxes the funds' trading on investors' behalf in stocks and derivatives. So I can buy shares in, say, Vanguard 500 Index Fund without paying this tax, but when Gus [Sauter] uses my money to buy stocks, the fund will be taxed. This can be a significant hit—even for an index fund that trades less than others. If the DeFazio-Harkin tax had been in place in 2008, we calculate that the tax burden would have been equivalent to one-third of the total expenses of equity index funds.

Second, the legislation also claims to exempt retirement plans and small investors from the tax, either directly or through tax credits. Here's the catch: As drafted, the bill does not allow mutual fund investors to claim those tax credits. So for the 79 million Americans whose long-term mutual funds will bear this tax, there is no escape.

Could those credits for retirement plans and small investors be passed along to mutual fund investors? We have had our operations experts look at what it would take to capture, on a daily basis, all of the information about trading and fund share ownership needed to calculate the tax for each individual shareholder. Funds, brokers, plans, and others would have to create brand-new systems to capture, calculate, retain, and report this tax information to investors—all at great expense, all ultimately borne by shareholders. So even if they could get a refund on the transaction tax, fund shareholders would be losers.

My third point concerns financial engineering. This tax is big enough to create real incentives for avoidance. It could drive trading offshore, as we've seen before: After Sweden instituted a transaction tax, half of trading in Swedish equities migrated elsewhere. Or we could see more debt instruments that imitate stocks—like exchange-traded notes, or the stock derivatives that traders in London use to avoid the U.K.'s Stamp Tax.

In short, this tax could spawn a whole new industry—financial engineering dedicated to avoiding the transaction tax—ironically, sending more investor dollars to Wall Street.

So how does this tax look for Main Street mutual fund investors who are saving for retirement, for college, or for other long-term needs? It's a direct hit on their financial goals—whether Congress tries to exempt them from it or not. Meanwhile, sophisticated large-scale investors, traders, and hedge funds will be finding ways around paying the tax. And that brings me to my conclusion: Put this tax on securities transactions, the big guys will avoid it—and the only ones hurt will be small investors.

Thank you for your time and attention.

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