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General Questions on Financial Transaction Taxes

1. What is a financial transaction tax (FTT)?

A financial transaction tax, also known as a securities transaction tax (STT), is a tax imposed on securities transfers, including purchases and sales. The tax could apply to the value of trades in stocks, bonds, derivative instruments, mutual funds, exchange-traded funds (ETFs), and other securities.

2. What is ICI's position on FTTs?

Though an FTT can be structured in a variety of ways, ICI believes that any such tax could harm individual fund investors who are investing to meet retirement, education, and other long-term financial goals. Click here for more detail on ICI's position on FTTs, particularly the following points:

- An FTT would be a tax on *all* investors, not just short-term investors.
- If applied to money market funds, such a tax would severely damage the industry.
- In addition to the direct costs of the tax, the tax is likely to have negative effects on all investors in the market and the broader economy.

3. What benefits do proponents of an FTT expect?

Proponents of FTTs cite the fact that an FTT would raise revenue for the government. Supporters of FTTs also believe that these taxes would improve the functioning of the markets and help long-term investors.

4. How would the proponents of an FTT expect these benefits to be achieved?

Supporters of FTTs believe that an FTT would improve market functioning and help long-term investors in several ways: by reducing stock price volatility; by discouraging what they perceive to be a short-term focus on the part of investors; and by reducing "financial engineering," or the creation of complex financial instruments. These arguments are advanced by such advocates as the Aspen Institute, the Economic Policy Institute (EPI), and the Center for Economic and Policy Research (CEPR). (See Claimed Benefits of a Financial Transaction Tax, Questions 14–18 below.)

5. Does experience and academic research support the views of FTT proponents?

The short answer is no, as is detailed in this FAQ and other materials.

There is no evidence that imposing a transaction tax reduces stock price volatility (see Question 15).

An FTT could discourage trading, particularly short-term trades. But there is little evidence to support the view that long-term trades are better for markets or for investors than short-term trades (see Question 16).

It is not clear that an FTT would discourage financial engineering, and it might even encourage the practice, given that financial firms would design products that reduce or avoid the FTT (see Question 17 below).

6. What would be the direct impact of a financial transaction tax on fund investors?

An FTT that applies broadly to stocks and bonds would raise funds' costs and reduce investment returns for shareholders in mutual funds, ETFs, and closed-end funds.

Funds trade their portfolio securities routinely as they invest shareholder cash, meet shareholder redemptions, and adjust fund portfolios. An FTT would raise transaction costs on all of those trades, and thus reduce shareholder returns.

If an FTT does not exempt trades in mutual fund shares, it would subject mutual fund shareholders to double taxation. A fund buyer would pay tax on both the purchase of fund shares and on the fund's portfolio trades. Shareholders in money market funds could be hit especially hard by the tax because many of these shareholders buy and sell shares frequently, as they use these accounts to manage their cash balances.

In addition to its direct costs, an FTT would likely reduce market liquidity (that is, the degree to which an asset can be bought or sold without affecting its price) and widen bid-ask spreads, further increasing investors' transaction costs.

7. How would a financial transaction tax affect the markets generally?

Regardless of how such a tax is structured, it would create market distortions that would reduce the efficiency of markets for all participants, including fund investors. The tax would reduce market volume and could have a negative impact on liquidity and price discovery—the process of determining market prices through the interaction of buyers and sellers.

8. How would a financial transaction tax reduce market volumes?

If the United States imposed an FTT, market volume on U.S. exchanges would decline, as some trades would become too costly to execute. Other trades would move off U.S. exchanges, as investors either move trading activity to other, lower-tax venues or trade more in alternate securities.

This happened, for example, after Sweden imposed such a tax and a large portion of trading in Swedish stocks migrated to London.

If the tax did not exempt trades made by intermediaries—such as market makers for individual securities—there would be an incentive to move trades from the public exchanges to alternative trading venues that directly match buyers and sellers.

Volume on U.S. exchanges would also decline if investors could avoid or reduce the tax by trading alternate securities. For example, even if the same tax rate applied to derivative transactions, if the tax was imposed on the net payments generated by derivative contracts rather than on notional value of the contracts, entering into a futures contract could allow an investor to replicate the returns of directly owning an equity but reduce the amount paid in transaction taxes. Similarly, if the tax were assessed on the notional value of derivative contracts but at a lower rate, entering into a futures contract could reduce transaction taxes relative to owning an equity directly.

9. How could a financial transaction tax have a negative impact on liquidity and the price-discovery process?

The tax could cause intermediaries, such as dealers and market makers, to be less willing to provide liquidity to the markets.

One way these intermediaries profit is by buying securities at a lower price (the “bid”) and selling them at a higher price (the “ask”). An FTT would reduce intermediaries’ profits and discourage them from trading unless spreads between bid and ask prices widened by at least the amount of the tax.

Price discovery could be impeded because investors would also be discouraged from trading. Investors trade when they obtain information that affects their estimate of the fundamental value of a firm. To overcome the increased cost of trading, investors would require a higher expected rate of return before they trade. That is, to act on new information, investors would require either a greater discrepancy between the stock’s current market price and their new estimate of the fundamental value of the firm, or more certainty surrounding their estimate. The tax’s barrier to trading would result in less interaction between buyers and sellers. Generally, greater interaction in markets results in more accurate price discovery.

10. Doesn’t the fact that other countries have financial transaction taxes reduce investors’ incentive to move their trading overseas?

Short of a worldwide agreement on a uniform FTT, imposition of an FTT in the United States would create incentives for investors to trade elsewhere. Indeed, imposition of an FTT in the United States—the world’s largest securities market—has the potential to prompt the development of a dominant global tax-free exchange.

11. Couldn’t a mutual fund minimize the effect of an FTT by making fewer portfolio transactions?

To operate efficiently, a mutual fund must make routine purchases and sales of securities to invest shareholder cash flows, obtain cash to meet investor redemptions, and adjust fund portfolios to implement the fund’s investment strategies as market conditions and the value of portfolio securities change. Introducing a tax incentive to avoid trading could distort funds’ decisions and make fund operations less efficient and more costly.

A stock fund’s adviser already has strong incentives to ensure that it doesn’t engage in portfolio trading—whether “too much” or “too little”—that harms the fund’s performance. If the cost of a fund’s trading activity exceeds the benefits in terms of improving the fund’s performance, investors may leave the fund.

12. Could an FTT be designed so that that it is difficult to avoid? Could an FTT be designed so that it is easy to administer?

A transaction tax could be difficult to avoid or easy to administer, but it is unlikely to be both.

The tax could be avoided simply by not trading. Indeed, one of the rationales for the tax is that it would reduce trading. However, the tax could also be avoided by changing the venue of the trade or the nature of the securities traded, as explained in the answer to Question 8 above.

To minimize avoidance, the base of the transaction tax would need to be as broad as possible. However, broadening the base would make the tax harder to administer. To discourage transactions from moving offshore, both transaction tax rates and tax compliance would need to be coordinated internationally. Enforcing the tax on private (off-exchange) transactions would require much more reporting than currently occurs. Similarly, no system tracks exchanges in nonregistered securities. In addition, developments in financial markets would need to be closely monitored, as there would be an incentive to devise new ways to avoid the tax, such as designing new financial instruments.

13. Doesn't an FTT have the potential to decrease the budget deficit?

Any tax has the potential to reduce the budget deficit. The question is, which taxes can raise revenue most efficiently with the fewest harmful side effects? An FTT would significantly impair the functioning of financial markets, imposing a very high cost on the economy relative to the revenues it generates.

Claimed Benefits of a Financial Transaction Tax

14. In addition to revenues for the federal government, what benefits do backers expect from FTTs?

Backers of a financial transaction tax claim several additional benefits, including:

- *Less volatility*: The Economic Policy Institute wrote that "the current upheaval in global financial markets has…given credence to the 'noise trader' approach, which argues that financial markets are prone to speculation, herd behavior, and excess volatility." In a paper on FTTs, Dean Baker, Codirector of the Center for Economic and Policy Research (CEPR), argues: "If there are substantial numbers of noise traders (traders who act based on market movements rather than an assessment of fundamentals) in the market, the reduction in trading volume induced by a transaction tax could actually reduce volatility since it can prevent price swings driven by momentum rather than fundamentals."
- *More long-term focus by investors*: A September 2009 Aspen Institute paper argued that "the focus of some short-term investors on quarterly earnings and other short-term metrics can harm the interests of shareholders seeking long-term growth and sustainable earnings, if managers and boards pursue strategies simply to satisfy those short-term investors. This, in turn, may put a corporation's future at risk." The report goes on to recommend "implementing an excise tax in ways that are designed to discourage excessive share trading and encourage longer-term share ownership."
- *Less financial engineering*: In an April 2009 editorial, CEPR's Dean Baker writes, "The financial engineers who specialize in constructing complex financial instruments may find an FTT to be a nuisance. An FTT could cause their derivative instruments to be taxed at several points. For example, the trade of an option on a stock would be taxed, as would the purchase of the stock itself if the option was exercised. More complex derivatives could be subject to the tax many times over,

substantially reducing the potential profits from complexity."

These hypotheses are premised on several beliefs regarding investor behavior held by proponents of the tax. We believe these assumptions are incorrect—see below for the reasons why.

15. Will an FTT reduce stock market volatility?

There is no evidence that imposing a transaction tax reduces stock price volatility.

To date, no studies have presented evidence of decreased stock price volatility in countries that implemented or increased FTTs. For example, using data from 23 countries from 1987 to 1989, Roll (1989) found that stock return volatility was not related to transaction taxes.[2] Looking at price volatility in Sweden before and after imposition of transaction tax in 1984, Umlauf (1993) found that price volatility did not decline.[3] Saporta and Kan (1997) found that the United Kingdom's stamp duty did not affect volatility of securities' prices.[4] Examining the effect of allowing negotiated commission in the United States in 1975, Jones and Seguin (1997) found no evidence that lowering commissions increased volatility.[5] Looking at the effect of changes in transaction taxes in Hong Kong, Japan, Korea, and Taiwan from 1975 to 1994, Hu (1998) found no significant effects on price volatility.[6] Examining smaller market segments, Habermeier and Kirilenko (2001) found that transaction taxes have negative effects on price discovery, volatility, and liquidity, and lead to a reduction in market efficiency.[7]

The expectation that an FTT would reduce stock price volatility is founded on the assumption that short-term investors trade based on speculation (i.e., they are "noise traders"), whereas long-term investors trade based on the fundamental value of a stock. There is no reason to believe this is a valid distinction. Short-term trades can be based on new information that alters market participants' estimates of the long-term fundamental value of a stock. Conversely, long-term trades can be speculative in nature, betting that the fundamental value of a firm will grow over time.

16. Will an FTT cause investors to take more of a long-term view?

No. That expectation is based on a misunderstanding of investor and market behavior.

The expectation that shareholders will become more patient is based on the belief that the market punishes corporations that undertake long-term investments. In practice, though the majority of stock trades are short-term, the stock market tends to reward corporations that undertake long-term investments. On average, announcements of long-term investments lead to an increase in a firm's stock prices,[8] particularly at firms that have valuable investment opportunities.[9]

17. Will an FTT reduce financial engineering?

An FTT may reduce some types of financial engineering, but it could also create new incentives to create complex financial instruments.

Engineered products that focus on short-term gains or that require multiple trades in securities subject to the tax would be negatively affected by an FTT. But much of what is called "financial engineering" is not motivated by short-term gains, nor is it executed with multiple trades. A fair amount of financial engineering is undertaken in response to government policies—for example, creating securities that are treated as equity for accounting or regulatory purposes, but that are treated as debt for tax purposes. As detailed in Question 21, imposition of an FTT could actually increase financial engineering, as Wall Street firms devise methods to avoid the tax.

18. Would an FTT reduce high-frequency trading and thus help financial markets?

An FTT would probably discourage high-frequency trading, but it is a very blunt instrument to use in reaching that goal. Any broad-based tax on securities transactions would have negative consequences for all investors.

Furthermore, the question of whether high-frequency trading harms or helps markets is not settled. High-frequency trading may, at times, benefit the markets by contributing liquidity and tightening bid-ask spreads. At the same time, high-frequency trading raises a number of regulatory issues that should be examined closely. That is why ICI supports efforts by the Securities and Exchange Commission (SEC) to examine market structure issues, including high-frequency trading.

Financial Transaction Taxes in the United States

19. Does the United States have a history of financial transaction taxes?

From 1914 to 1965, the federal government did impose a financial transaction tax. This FTT was initially 2 basis points (0.02 percent) in 1914, increased to a range of between 4 and 6 basis points from 1932 through 1958, and reverted to 4 basis points from 1959 until the tax was repealed in 1965.

20. Are there any FTTs currently in place in the United States?

Currently, the SEC imposes a "Section 31 fee" on stock transactions, and the proceeds of this FTT are used to fund the agency. More information on this fee can be found on the SEC website.

21. Has an FTT been proposed recently in the United Sates?

Several FTT proposals have been floated in recent years. The FTT imposed in the United States between 1914 and 1965 only taxed stock transfers, but recent proposals to revive the tax also include a number of other types of securities, including partnership interests, note, bonds, debentures or other evidence of indebtedness, and interests in derivative financial instruments, such as options, futures, and swaps.

22. Would an FTT imposed today have a similar effect on the financial markets as the FTT in the United States between 1959 and 1965?

No. An FTT of any given magnitude would have a far greater impact on investor returns today than historically. Overall transaction costs have declined markedly since 1965, so a tax would represent a much greater increase in costs, proportionately.

Financial Transactions Taxes in the United Kingdom and Sweden

23. Isn't there a financial transaction tax in the United Kingdom?

Yes. The United Kingdom has a stamp duty. The tax rate is 50 basis points, or 0.5 percent. The UK law differs from some FTT proposals in the United States in that UK tax law exempts intermediaries from the tax on securities purchases. This is a significant difference because intermediaries facilitate many stock exchange trades.

Typically, one long-term investor does not sell a block of shares to another long-term investor looking to buy the same number of shares. Instead, investors usually trade through market makers, dealers, or other intermediaries, who provide liquidity by constantly buying and selling shares on the market and from their own inventory. Under the UK stamp duty, intermediaries are exempt from tax, so such trades are taxed only once, when an investor buys shares from an intermediary and pays the tax. Under FTT proposals that include securities purchases made by intermediates, such trades that provide market liquidity would be taxed twice—once when an intermediary purchases the shares from an investor, and again when another investor later buys the shares from the intermediary.

24. What impact has the UK stamp tax had on market liquidity in the United Kingdom?

It is noteworthy that the UK stock market is much less liquid than the U.S. stock market. According to figures presented by Gus Sauter, former chief investment officer of the Vanguard Group,[10] in 2009 average daily turnover in the UK stock market was 0.37 percent—approximately one-quarter the 1.38 percent average daily turnover in the U.S. stock market. Moreover, turnover in the UK market would likely be even lower if liquidity-providing intermediaries were subject to the tax, as they would be under some recent FTT proposals in the United States.

25. What effect has the UK stamp tax had on securities trading in the United Kingdom?

The stamp tax has caused much of the trading in the United Kingdom to migrate to securities that are exempt from the tax, with several results:

- Trading in equities in the United Kingdom has declined, while trading in options and derivatives—which are not subject to the UK tax—has increased.[11]
- Trading in American Depository Receipts (ADRs) of UK firms by UK investors rather than trading shares of the firms on the London exchange, has increased.[12]

- Use of Contracts for Differences (CFDs), which are derivatives transactions, by UK investors to avoid the transaction tax has increased.[13]

26. Did Sweden have a financial transaction tax?

Yes. The tax was introduced in January 1984. Both purchases and sales of domestic equities were taxed at 0.5 percent (50 basis points) for a combined 1 percent tax on each transaction. Trading in stock options was also taxed. In July 1986, the tax rate was doubled. In 1989, the tax was extended to trading in fixed-income securities and derivatives, but at lower rates than those applied to stock trades.

27. What were the effects on stock trading from Sweden's FTT?

After Sweden doubled the transaction tax rate in 1986, Umlauf (1993) found that 60 percent of the volume of the 11 most actively traded Swedish stocks migrated to London.[14] That shift represented 30 percent of all trading volume in Swedish equities. By 1990, 50 percent of all trading in Swedish equities had migrated.

In a separate study, Campbell and Froot (1995) found that only 27 percent of the trading volume in Ericsson, a major company based in Sweden, took place on the Stockholm exchange in 1988.[15]

Umlauf also looked at stock price volatility in Sweden before and after imposition of the transaction tax in 1984, and found that price volatility did not decline.

28. Does Sweden still have a financial transaction tax?

No. Sweden began phasing out the tax in 1990 and abolished it in December 1991.

ENDNOTES

[1] This discussion of the empirical evidence on the effects of a transaction tax on financial markets was written in early 2010. Two recent studies look at the empirical evidence and reach conclusions very similar to those presented below, particularly regarding the potential of an FTT to reduce stock market volatility. See Thornton Matheson, 2011, "Taxing Financial Transactions: Issues and Evidence," IMF Working Paper WP/11/54. See also Neil McCulloch and Graxia Pacillo, 2011, "The Tobin Tax—A Review of the Evidence," Institute of Development Studies Research Report, 68. For an additional discussion of the likely impact of a transaction tax on the functioning of the financial markets, see Congressional Budget Office, 2011, "Response to Questions About the Effects of a Tax on Financial Transactions That Would Be Imposed by the Wall Street Trading and Speculators Tax," December 12. Available online at www.cbo.gov/ftpdocs/125xx/doc12576/12-12-2011_Hatch_Letter.pdf.

[2] Richard Roll, 1989, "Price Volatility, International Market Links, and Their Implicatons for Regulatory Policies," *Journal of Financial Services Research* 3, 211–246.

[3] Steven R. Umlauf, 1993, "Transaction Taxes and the Behavior of the Swedish Stock Market," *Journal of Financial Economics* 33, 227–240.

[4] Victoria Saporta and Kahmhon Kan, 1997, “The Effects of Stamp Duty on the Level and Volatility of UK Equity Prices,” Working Paper, Bank of England.

[5] Charles M. Jones and Paul J. Sequin, 1997, “Transaction Costs and Price Volatility: Evidence from Commission Deregulation,” *American Economic Review* 87, 728–737.

[6] Shing-yang Hu, 1998, “The Effects of the Stock Transaction Tax on the Stock Market—Experiences from Asian Markets,” *Pacific-Basin Finance Journal* 6, 347–364.

[7] Karl Habermeier and Andrei Kirilenko, 2001, “Securities Transaction Taxes and Financial Markets,” IMF Working Paper.

[8] Donald W. Kiefer, 1990, “The Securities Transactions Tax: an Overview of the Issues,” *CRS Report for Congress*, July 25.

[9] Kee H. Chung, Peter Wright, and Charlie Charoenwong, 1998, “Investment Opportunities and Market Reaction to Cpital Expenditure Decisions,” *Journal of Banking and Finance* 22.

[10] “Financial Transactions Tax: Taxing U.S. Investment, Savings, and Growth,” December 16, 2009, www.uschamber.com/webcasts/2009/091216_ccmc_ftt.htm (video) at 16:45 minutes.

[11] Government of Canada, Depository Services Program, 1996, *Financial Transactions Taxes: The International Experience and the Lessons for Canada*. Available at http://dsp-psd.pwgsc.gc.ca/Collection-R/LoPBdP/BP/bp419-e.htm.

[12] Ibid.

[13] EU Clearing and Settlement Fiscal Compliance Experts’ Group, 2006, *Fact-Finding Study on Fiscal Compliance Procedures Related to Clearing and Settlement Within the EU*. Available at http://ec.europa.eu/internal_market/financial-markets/docs/compliance/ff_study_en.pdf.

[14] Umlauf 1993.

[15] John Y. Campbell and Kenneth A. Froot, 1995, “Securities Transaction Taxes: What About International Experiences and Migrating Markets,” *Securities Transaction Taxes: False Hopes and Unintended Consequences*, Catalyst Institute.

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