Understanding and Evaluating a Financial Transaction Tax

Introduction

Recently, a group of Reddit users generated national financial controversy. The users, members of the popular "r/wallstreetbets" Reddit community, squeezed out short-selling hedge funds by driving shares of GameStop up 1,500% in two weeks.[1] The movement was driven primarily by retail investors – non-professional, individual investors empowered by trading platforms like Robinhood. The new phenomenon, brought about by the ability of retail investors to act in concert with one another, caused concern among those within the financial community. They fear that massive losses by hedge funds could affect other market sectors.[2] Others viewed the controversy as an underdog story of small-scale investors taking on elite financial managers.[3]

The GameStop issue renewed proposals for a financial transaction tax (FTT) to curb speculative trading. Such a tax would, in proponents' view, restrict "excessive trading that is designed to manipulate the markets instead of benefiting the overall economy."[4] However, in seeking to disempower one class of Americans, an FTT would likely divert funding from other, worthwhile sources while only negligibly (if at all) fulfilling its stated objectives.

Key Points

- Research reveals FTTs neither effectively reduce volatility nor efficiently raise revenue.
- FTTs may harm institutional investors, potentially cutting pension plans, retirement savings accounts, and university endowments.
- Kentucky's savers rely upon a number of institutions which could be affected by an FTT.

Understanding the Issue

Short Selling

Short selling is an investment strategy whereby an investor "borrows" a security he or she believes will decrease in value. The investor sells the borrowed security at market price, hoping that its value will continue to decrease. If the price continues to drop, the investor can repurchase the security at a lower price before returning it to the lender, thus profiting from the difference between the initial sale price and the price of repurchase.

High-Frequency Trading

Short selling is often associated with a market practice known as high-frequency trading (HFT). High-frequency trades rely upon investors' ability to make many trades within short time frames.[5] Such trades make up a considerable portion of U.S. trading volume, and their effects include improved liquidity and price discovery.[6] However, some HFT-oriented firms' practices have drawn scrutiny, including frontrunning and slow-market arbitrage.[7] Though HFT equity revenues have recently declined, high-frequency trades remain the subject of regulatory efforts to curb illicit or volatile engagement within the market.[8] Put simply, there is concern that the ability to sell large volumes in a short amount of time (high frequency trading) will lead to market volatility.

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Financial Transaction Taxes

One solution suggested by the critics of high-frequency trading is a financial transactions tax (FTT) –a tax imposed on the buyer or seller of a security at the time of transaction.[9] Proponents of the tax argue that taxing each trade will curb high-frequency trading, which can involve large numbers of trades in fractions of a second. Further, it would be a considerable source of revenue.[10]

Opponents of financial transaction taxes warn that it would introduce distortions into the marketplace and raise the cost of capital for businesses seeking to finance investment. Additionally, opponents cast doubt on the suitability of an FTT as a revenue-generating policy, arguing that any revenue garnered from an FTT would be offset by reductions in the market. Moreover, opponents argue that regulatory tools may be more appropriate methods to curb volatility and increase transparency.

Impact of Financial Transaction Taxes

Market Effects

A study by the Committee on Capital Markets Regulation reviewed seventeen empirical studies of the impact of FTTs on markets and investors in the United States, Europe, and Asia. The study concluded that FTTs across the globe have had a "consistently negative impact," by increasing trading costs and decreasing stock prices.[11]

There is consensus that implementing FTTs will decrease high-frequency trading, but its ability to decrease volatility and increase revenue remains unclear.[12] The majority of empirical studies evaluating FTTs have found that they either have no effect on volatility or that they increase volatility, though the research is limited by the fact that the majority of these studies were done before there was a sizable increase in HFT trading. While revenue estimates vary by design and modeling assumptions, researchers generally acknowledge a fair amount of uncertainty about the revenue-raising potential of FTTs.[13]

The potential revenue generated from FTTs is entirely dependent on the tax's design and the size of the market to which it is applied. Therefore, the potential revenue would likely be offset, at least marginally, by reductions in market trading because of the tax. A high or too narrowly tailored tax could cause traders to either flee the market or to engineer "synthetic" securities that generate the same return but are not subject to the tax.[14] Additionally, the impact of FTTs could trickle down to the general public if parties subjected to FTTs raise prices and subsequently pass additional costs to consumers or shareholders.[15]

FTTs increase the cost of capital, reduce asset value, and reduce trading volume, but their precise impacts depend on elasticity-determining market characteristics.[16] Elasticity under a national tax is uncertain, but the imposition of an FTT by a single state would likely have higher elasticity because of the ease with which activity could move to non-taxed jurisdictions.[17] Moreover, the ease of movement between state jurisdictions also means that negative effects on volume from a state-level FTT would likely be more significant than a federal FTT. A reduction in trading volume would reduce both the overall FTT revenue and revenue garnered from state income taxes and capital gains.[18]

Effect on Savings Plans

The International Monetary Fund warned that FTTs are not only inefficient revenue tools but that their cost is experienced by more than just wealthy investors, as proponents claim. Implementing an FTT could affect the middle class by means of cuts to "pensions, mutual funds, and other vehicles of middle-class saving."[19]

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A study conducted by the Modern Markets Initiative describes the effects of a proposed FTT before Congress that would place a tax ranging from 0.02-0.5 percent on all equity, debt, and derivatives trades. The report concludes that the tax would devastate American savers.[20] A few key costs of an FTT include:

- $422 million annually for public and private university endowments.
- $75 to $100 million for the typical state pension plan.
- $45,000 to $65,000 over the lifetime of a single 401(k) account—which is the equivalent of delaying retirement for the average individual by approximately two years.

Effect in Kentucky

Research from Pew Charitable Trusts (2016) indicates that 51% of Kentucky workers are participating in a workplace retirement plan such as a 401(k) or a pension plan—nearly 970,000 Kentuckians. Of those, nearly 480,000 were enrolled in pension plans in 2020.[21]

Kentucky's pension plan is already in crisis—over $43 billion in debt and one of the most underfunded pension plans in the nation.[22] To further burden Kentucky pensions with an FTT would cause unnecessary damage to a system already in disarray.

An FTT would affect a sizable number of university students as well. The 2020 Historic Endowment Study from The National Association of College and University Business Officers (NACUBO) reveals that endowments of Kentucky's public and private universities serve over 100,000 students and have a total market value of over $4.5 billion.[23]

Hundreds of thousands of Kentuckians' savings plans and scholarships could be affected by a potential FTT. By taxing financial transactions, an FTT may well harm the institutional investors who are responsible for the financial savings and academic achievement of many Kentuckians—two particularly important factors for securing economic stability.[24]

Conclusion

Research on FTTs reveals that they are not particularly effective at reducing volatility and are inefficient sources of revenue. Aside from the fact that an FTT would only nominally (if at all) fulfill its stated objectives, the tax would harm Kentuckians, especially Kentucky students and retirees who depend on university endowments and retirement savings accounts.

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