WebMemo
Published by The Heritage Foundation

No. 3456
January 11, 2012

Financial Transactions Tax Would Hurt the Economy and Kill American Jobs

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The Congressional Budget Office (CBO) warns that a tax on certain financial transactions could "diminish the importance of the United States as a major financial market" and that, in the short run, "imposing the transaction tax would probably reduce output and employment."[1] While these effects would be "mitigated" if other financial centers introduced a similar tax, strong opposition in Britain and Canada[2] makes such a universal tax very unlikely.

While the CBO letter deals with the effects of the recent Wall Street Trading and Speculators Tax Act, which was introduced as S. 1787 by Senator Tom Harkin (D–IA) and as H.R. 3313 by Representative Peter DeFazio (D–OR), the same judgment could also be applied to other versions of the tax designed to punish the finance industry for its role in the 2008 global financial crisis,[3] lower the deficit or pay for new spending,[4] or as an international scheme where multiple nations enact the levy to pay for climate change policies[5] or fund the European Union.[6]

A financial transactions tax would weaken the already frail recovery and harm average investors who are saving for retirement as much as or more than it would harm the high-frequency traders, one of the targets of this misguided tax. A financial transactions tax has always struggled to gain traction with Congress in the past, and that should remain the case.

What Is a Financial Transactions Tax? While a financial transactions tax can take several forms, almost all proposals charge a tax equal to a supposedly tiny proportion of the targeted transaction. For instance, the proposed tax in the Harkin–DeFazio bills would amount to 0.03 percent of the value of a stock or bond transaction and 0.03 percent of the actual payment made for a derivatives contract. Other versions would make the tax a fixed amount for each share, bond, or other instrumented traded.

Backers of the tax often wrongly argue that the low rate or small fixed fee would have little impact on financial markets or the economy. They are wrong, and this impact would be magnified by the fact that the tax would apply to transactions by and for financial institutions and those that are made by financial intermediaries that manage assets owned by small investors such as pension funds, mutual funds, and similar entities.

For a time, the tax could raise a significant amount of money, especially if legislators decided to increase the tax rate at some point in the future.

This paper, in its entirety, can be found at:
http://report.heritage.org/wm3456

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

However, the additional revenue would almost certainly go to fund additional spending rather than to reduce the huge federal deficit. Of course, once the tax had sufficiently damaged both the financial sector and the economy, revenues from the transactions tax would decline, leaving the new spending to be funded from borrowing or some other new revenue source.

Harmful to the Economy. What supporters of a financial transactions tax, levied in either manner and at any level, fail to understand is that even a supposedly tiny tax may greatly exceed the amount of profit that the financial institutions receive for executing the transaction. While the total value of a single transaction might amount to many millions or even billions of dollars, the profit margin might equal only a cent or more.[7] For instance, a block of a million shares of a $25 stock that is sold for $25.01 would see the proposed fee eat about 75 percent of the profit made from the sale. For this reason, the proposed fee would be added to the cost of the asset and not absorbed by the financial institution. This would have a powerful negative impact on the economy.

The CBO rarely issues such decisive reports on the many issues it analyzes for Congress. In this recent report, however, it laid out unequivocally the harmful impact of a financial transactions tax:

> The tax would raise the cost of financial transactions. Securities that are traded frequently, such as Treasury securities, would be more affected than securities that are traded less frequently. The tax would also decrease the volume of transactions and would make some types of trading activity—such as derivatives transactions to manage risk and computer-assisted high-frequency trading—unprofitable.… Because of economies of scale in trading markets, as foreign holders of U.S. securities moved their transactions abroad, more of the market could go with them, which could diminish the importance of the United States as a major global financial market.[8]

The U.S. has a large comparative advantage in the financial industry relative to other developed nations. This remains true despite actions by Congress, such as the Sarbanes–Oxley law passed early in the past decade and the recent Dodd–Frank law

1. Douglas W. Elmendorf, Director, Congressional Budget Office, letter to the Honorable Orrin G. Hatch, Ranking Member, Committee on Finance, U.S. Senate, December 12, 2011, at *http://www.cbo.gov/ftpdocs/125xx/doc12576/12-12-2011_Hatch_Letter.pdf* (January 9, 2012).
2. Louise Armitstead and Bruno Waterfield, "EU Financial Transaction Tax 'Would Harm UK,'" *The Telegraph*, September 28, 2011, at *http://www.telegraph.co.uk/finance/financialcrisis/8795426/EU-financial-transaction-tax-would-harm-UK.html* (January 9, 2012); Robin Emmott and John McCrank, "UPDATE 1-EU Calls for Global Tax, Canada Says Can Block It," Reuters, October 5, 2011, at *http://www.reuters.com/article/2011/10/05/eurozone-tax-idUSN1E7940VN20111005* (January 9, 2012).
3. David C. John, "The Financial Crisis Responsibility Fee: The Wrong 'Solution,'" testimony before the Committee on Finance, U.S. Senate, May 11, 2010, at *http://www.heritage.org/research/testimony/the-financial-crisis-responsibility-fee-the-wrong-solution*.
4. Patrick Temple-West, "Democrats Revive Financial Transaction Tax Idea," Reuters, November 2, 2011, at *http://www.reuters.com/article/2011/11/02/us-usa-tax-transaction-idUSTRE7A175U20111102* (January 9, 2012).
5. Joel Gehrke, "Report: Obama, UN to Tax US for Green Climate Fund," *The Examiner*, December 5, 2011, at *http://campaign2012.washingtonexaminer.com/blogs/beltway-confidential/report-un-tax-americans-green-climate-fund/237466* (January 9, 2012).
6. Press release, "Financial Transaction Tax: Making the Financial Sector Pay Its Fair Share," European Commission, September 28, 2011, at *http://europa.eu/rapid/pressReleasesAction.do?reference=IP/11/1085* (January 9, 2012).
7. Dennis Dick, "Financial Transaction Tax Will Punish Main St., Not Wall St.," *Tabb Forum*, November 10, 2011, at *http://www.tabbforum.com/opinions/financial-transaction-tax-will-punish-main-st-dot-not-wall-st-dot* (January 9, 2012).
8. Elmendorf, letter to Hatch.

that inflicted onerous requirements and regulations on the industry. These actions have already driven some of the industry overseas.

A financial transactions tax, as CBO says, would drive the portion of the industry that conducts high-volume trading, along with other substantial parts of the industry, overseas. This would diminish the importance of the U.S. as an integral financial center and greatly reduce the economic benefits that come with it. Among other things, thousands of high-paying jobs would leave the U.S., sharply reducing employment at hundreds of non-financial companies that depend on these people for customers.

Hurts the Smaller Investor. As noted above, the tax would apply to trades made by fund managers handling investments in funds such as 401(k) and similar retirement savings plans, IRAs, 529 college savings plans, annuities, and a host of other intermediaries whose customers are usually moderate-income individuals. Because the tax would often exceed any trading profit, it would be deducted from the value of the underlying investments. This would reduce the investment growth of retirement and college savings plans, causing account owners to have smaller retirement incomes and making it harder to meet tuition bills. It would also make it harder to save for a down payment on a home and a number of other savings goals.

Because the tax is likely to be higher than the profit available to financial institutions, it would have a "lock-in effect" similar to that of the capital gains tax. This occurs when investors hold on to assets that offer a lower return rather than sell them to purchase assets with better returns in order to avoid paying the capital gains tax. The same thing would occur with a financial transactions tax: Investors would hold on to underperforming assets too long, thus reducing the value of the investment.

Unintended Victims. While supporters of the financial transactions tax claim that it would rein in Wall Street speculators, the reality is very different. The tax would not hurt these high-volume traders, who would move their activities offshore to escape the tax. It is average investors who would instead bear the burden of the tax when their portfolios fall in value and suffer from damage to the overall economy.

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