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Viewpoint: Tax Proposal Is as Bad as It Ever Was

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By Menachem Brenner

The idea of a financial transactions tax, also known as the "Tobin Tax," is an old one, but in the wake of the financial crisis it is quickly gaining favor in Europe and the U.S.

European Union leaders are urging the International Monetary Fund to consider a global tax on financial transactions. Though the U.S. Treasury Department opposes the idea, Sen. Tom Harkin and Rep. Peter Defazio support it in a bill they have introduced.

They are not alone. In the past few months heads of states, regulators, labor unions and others have proposed a financial transactions tax, saying it will extract from financial institutions money that will be used for a variety of "good" causes and at the same time reduce speculation.

Those favoring this scheme point to its ease of implementation and say it would bring in, by some generous estimates, $150 billion a year in the U.S. alone. This, however, assumes that the tax would not affect transactions volume In addition, proponents claim that the tax will divert the focus, of shareholders and managers alike, from short-term performance and will reduce "excess" volatility in the market.

Such claims are unsupported by even simple economic principles, and the available evidence points to the negative consequences of such a tax.

There is no question that a transaction tax is easy to implement and administer. This ease of implementation, however, is negligible when weighed against the damage it will cause. A transaction tax will reduce trading volume, because traders will trade less and the resulting reduction in market liquidity will have several negative effects.

First, the value of financial assets, stocks and bonds, will decline as a result of lower liquidity. Second, in contrast to the claims of the tax proponents, the volatility of financial asset prices will worsen. A capital market too thin to immediately adjust to relevant information is not operating efficiently. Price movements become discontinuous, more jumpy, resulting in increased volatility. The immediate impact of lower trade volume and the resulting lower asset prices will be the reduction of the very tax revenues for which the scheme was designed. Moreover, the decline in the value of assets creates capital

losses, which will be offset against previous capital gains, though this will have a one-time effect.

The financial markets will not be the only ones to suffer a direct hit from this tax. Increasing inefficiency in the secondary market makes investors more inclined to participate in the primary market. Companies will find it harder to raise capital from the public, resulting in a decline in investment in the economy and, in turn, a decline in corporate tax revenues. Worse, domestic and foreign investors will migrate to markets that do not impose a transactions tax, as documented in a study on 20 countries.

The proposed tax, which will also apply to derivatives, will discourage hedging activities, resulting in fewer investments in risky assets. It will also discourage arbitrage activities that align prices across various markets and make them more efficient.

In the early 1990s the U.S. considered levying a securities transaction tax but decided emphatically to shelve the proposal, and other countries took similar action. Most European nations have either annulled or drastically lowered transaction taxes.

The "Swedish Experiment" provides one example of the ill effects of a transactions tax. The tax, imposed in the late 1980s, hurt trading volume on the Swedish exchange, and trading shifted to London or to assets that were exempt from the tax. After Swedish economists and, eventually, the politicians realized the damage they had caused, they eliminated the tax.

Imposition of a transaction tax will be an unwelcome jolt to the fragile markets and this economy. It will cause significant harm to the financial markets and the economy as a whole and should not be promoted as a solution.

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