INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

Financial Transaction Taxes Harm Small Investors and the Economy

Executive Summary

A financial transaction tax (FTT) is a tax typically imposed on the purchase and sale of securities, such as stocks, bonds, derivative instruments, mutual funds, and exchange-traded funds (ETFs). The tax—at rates varying between 0.03% and 0.5% under recent proposals—typically would be applied to the value of the securities transferred.

While an FTT could be structured in a variety of ways, any such tax would harm individual investors who are saving to meet retirement, education, and other financial goals. FTTs do not fall on just financial institutions or high-frequency traders—the incidence of the tax falls on all investors.

FTTs Harm Investors

Levying an FTT would raise transaction costs on all trades, which would produce a constant drag on shareholder returns. Diminished returns make it harder for investors to achieve retirement security and other goals. FTT supporters cast the tax as a small burden, pointing to the tax's ostensibly low rate. But for investors, the impact of an FTT would be substantial.

The tax would harm investors who buy and sell shares of funds in the course of normal saving and investing activities. It would hurt investors who, for example, periodically rebalance their portfolios, sell fund shares to make purchases or pay taxes, reinvest distributions from dividends and capital gains, and roll-over a 401(k) when they change jobs.

The tax would also harm fund investors who make a single fund purchase and then hold it for the long-term because the fund's portfolio managers must transact every day—they routinely trade their portfolio securities as they invest new shareholder cash, meet shareholder redemptions, and adjust fund portfolio holdings.

Shareholders in money market funds, as discussed in detail below, would be especially hard hit by an FTT. Many of these shareholders buy and sell shares frequently, as they use these accounts to manage their cash balances. Additionally, the portfolios of these funds turn over frequently because of portfolio restrictions imposed by federal securities laws. Taxes imposed on these transactions would fall directly on the funds' shareholders through diminished returns.

Impose Tremendous Costs on Fund Investors

A 25 basis point FTT[1] could increase the cost of buying and selling stocks by an estimated 25 to 60 percent. These costs would cause fund investors to lose tremendous value in their investments, and would impede investors' ability to meet their savings goals.

Had a 25 basis point FTT been in place in 2011, mutual fund shareholders in stock, bond, and hybrid funds would have had their returns reduced by $56 billion.

- $14 billion of tax would have been collected on the purchases and sales by mutual fund shareholders of nearly $5.7 trillion in shares of stock, bond, and hybrid mutual funds.
- $41.5 billion of tax (equal to a reduction in fund returns of 46 basis points) would have been collected on the $16.6 trillion of portfolio trades by stock, bond and hybrid mutual funds themselves.
- $600 million of tax would have been collected on the $241 billion of paid capital gain and dividend distributions that shareholders reinvested in stock, bond and hybrid funds.

FTTs Undermine Good Tax Policy

Multiple Layers of Taxation. FTTs can result in fund investors incurring multiple levels of tax. A tax that applies to fund and investor transactions would cause the investor to be taxed on purchases of fund shares, taxed again as the fund puts that money to work in the market, taxed yet again when the fund sells shares to meet a redemption request, and taxed a fourth time when the shareholder redeems. Quadruple taxation is neither inconsequential nor, as a matter of tax policy, fair.

Tax Otherwise Tax-Exempt Investors. Because funds themselves would bear FTT on portfolio transactions, a fund's tax-exempt investors (such as retirement accounts) effectively would pay the tax—even though such tax may not have been due had they invested directly, outside the fund, in the same securities.

FTTs Create Problems Without Simple Solutions

Some have suggested that the impact of an FTT on small investors could be addressed by creating exemptions based on income levels or dollar amounts of transactions. Such fixes create their own problems. Setting up a mechanism to compensate investors for their share of any tax imposed on the fund's portfolio transactions, such as through a tax refund, would be highly difficult to develop and administer.

Another attempt to fix a broken FTT system may be to design a procedure to permit a fund to flow-through the portfolio-level taxes to its shareholders. This would necessitate the creation of highly complex reporting mechanisms at substantial cost to both funds and the government. Since fund shares are held not only through the funds themselves, but also through

[1] An FTT of 25 basis points was proposed in 2009 by Senator Harkin (S.2927) and Representative DeFazio (H.R.4191). A 2012 proposal by Representative Ellison (H.R. 6411) would have imposed an FTT at double that rate.

various intermediaries in omnibus accounts, the costs of disseminating this information would be substantial.

FTTs Reward Financial Engineering

FTT supporters put forward that the tax would tamp down speculative, computer-driven trading and financial engineering, thus re-directing resources to the "real" economy. In fact, the opposite would happen; imposing an FTT leads to more financial engineering causing the tax burden to fall disproportionately on small investors.

For example, after France enacted its FTT in August 2012, trades in covered stocks declined by 16 percent[2] in the three months after the tax was applied, while trades in non-covered derivative products spiked by 20-25 percent. The French finance ministry, French traders and French financial analysts so far agree on only one thing regarding the new tax—large players are able to skirt the French FTT using an array of financial engineering techniques, leaving small investors bearing the burden.

FTTs Disproportionately Impact Money Market Funds

FTTs would hit millions of money market fund shareholders especially hard. First, these investors tend to move money in and out of these funds more frequently to meet short-term cash needs—including for example payroll. For money market fund investors, an FTT would be equivalent to a tax on writing checks to pay their bills or manage their cash positions.

Second, managers of money market funds limit their risks and maintain stability through investments in short-term securities. Holding short-term securities necessarily means higher portfolio turnover. FTTs significantly drive up fund costs, which investors ultimately bear in the form of lower returns or having to move to less attractive cash management products.

In 2011, money market fund shareholders purchased and sold $30 trillion in shares—about 11 times the average level of total net assets for the industry in the year. Given a 25 basis point FTT, shareholders would have incurred an additional expense of $75 billion just to use money market funds. As such, money market fund investors would seek out a non-taxed alternative, either domestically or overseas, especially in the low interest rate environment we are experiencing currently. Less cash invested in money market funds could cause a significant reduction in the supply of short-term credit to corporate America unless banks raised substantial amounts of capital to be able to support their expanded balance sheets.

Even with an exemption for money market fund shareholder transactions, the future of the money fund industry would still be at risk. This concern is particularly acute in today's low interest rate environment (in which yields have dropped to an average of 0.05% from 4.97% in 2007). A transaction tax on a money market fund's portfolio investment activities could easily cost more than the interest earned on the securities, particularly if the tax were paid on overnight repurchase agreements.

[2] The trading drop-off was deeper in lower-capitalized stocks subject to the French FTT, suggesting that mid-sized firms are disproportionately hurt by the tax.

FTTs Harm Markets

FTTs make markets less efficient by reducing market volumes, thereby impairing liquidity and distorting price discovery. No matter how an FTT were structured, it would create market distortions that reduce the efficiency of markets for all participants, including fund investors.

An FTT would degrade the competitiveness of the U.S. capital markets and cause trading to migrate to less costly foreign venues.

Consider Sweden, which adopted an FTT in 1984. After the country doubled its transaction tax rate in 1986, half of all trading in Swedish equities migrated outside the country, primarily to London. Burned by the experience, Sweden got rid of its FTT in 1991.

France enacted its FTT in August 2012 and already has begun to experience similar declines in trading volume. European institutional investors have been frank with their French brokers about their intent to substitute equivalent European securities for French securities as portfolios are rebalanced.