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March 28, 2019

Financial Transaction Taxes Harm Small Investors and the Capital Markets

Financial transaction taxes (FTTs) harm individual investors who are saving to meet retirement, education, and other financial goals. Mutual fund investors would be harmed by a proposal under consideration that would impose a 0.1-percent (10-basis-point) tax on the value of securities transferred.

FTTs Harm Investors

- FTTs do not fall just on financial institutions, high-frequency traders, or "high-rollers."
  - While it is true that the mutual fund would "pay" the tax on its portfolio trades, the full cost of the tax would fall on the fund's shareholders—who are the fund's sole owners and bear all of its expenses.
  - Moreover, any tax on an individual's redemptions of fund shares would fall on the shareholder—either directly (if the tax is "paid" by the shareholder through lower sales proceeds) or indirectly (if the tax instead is "paid" by the fund and reduces its net assets).
  - The tax would harm investors who periodically rebalance their portfolios, sell fund shares to make purchases or pay taxes, take distributions in retirement, and roll-over a 401(k) when they change jobs.
- An FTT would reduce the savings of tens of millions of middle-income households that own mutual funds, IRAs, or defined contribution accounts.
  - 44 million US households that own mutual funds, IRAs, or defined contribution accounts have incomes of less than $100,000 (67 million have less than $200,000).
  - These households (less than $100,000 and $200,000, respectively) represent 58 percent and 89 percent of all US households that own mutual funds, IRAs, or defined contribution accounts.
- 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.
  - According to an ICI analysis, a 10-basis-point FTT would have reduced the returns of long-term mutual funds by $23 billion during 2018 (a reduction in fund returns of 14 basis points).
  - Money market fund investors would have fared even worse, suffering an estimated $20 billion in additional costs due to the tax—a reduction of 71 basis points in return. In this low short-

term interest rate environment, that tax cost would be a substantial hit to money market fund investors.

- While a 10-basis-point tax may sound "small," the reduced investment return attributable to the tax would have the same effect as a 31-percent increase in the average expense ratio that 401(k) plan participants incur for investing in equity mutual funds. For equity index fund investors, the effect would be the same as a 60-percent increase in the average expense ratio—pushing expenses on these funds to a level not seen since 2010.

FTTs Undermine Good Tax Policy and Harm Markets

- Well-established tax policy goals of increasing savings would be undermined.
  - Fund investors would incur multiple levels of tax on every dollar that they invest.
    - Tax would be owed when a fund purchasing securities with investors' savings.
    - Tax would be owed twice more when the fund sells securities to finance shareholders' redemptions and the shareholders then redeem those fund shares.
    - In effect, FTT would be paid three times each time an investor acquires fund shares—even though the fund share acquisition presumably would be exempt as an "initial issuance."
    - The tax also would be paid on portfolio transactions made by the fund to enhance investor returns in response to changing market conditions.
  - Tax would be owed by otherwise exempt investors.
    - Retirement accounts and pension funds would be taxed—and taxed repeatedly (just like fund investors).
    - Foreign investors in US debt instruments would incur tax—even though US tax law exempts this interest income from tax to encourage foreign investment.
- Financial engineering would be rewarded as sophisticated investors find ways to avoid the FTT. The tax burden would fall disproportionately on small investors.
- FTTs harm markets by making them less efficient through reduced trading volume, impaired liquidity and distorted price discovery.
- There is no evidence of the purported benefits of an FTT. In fact, most studies have found that FTTs have either no effect on market volatility or increase it.
- An FTT also would harm the US capital markets by degrading their competitiveness and causing trading to migrate to lower-tax foreign venues. Consider these European examples:

- Sweden 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 and Italy both experienced immediate declines in trading volume after their FTTs became effective in 2012 and 2013, respectively. Neither raised even half, during their first year of effect, of what was projected. Moreover, there is evidence of firms purchasing securities of issuers located in other European countries as substitutes for French or Italian securities.

- The European Commission's FTT proposal has not gained traction, perhaps due to the negative consequences in France and Italy, since it was proposed in 2012. Indeed, the strong opposition from several countries led eleven countries to consider an FTT under a special "enhanced cooperation" procedure. One of the eleven then dropped out. The remaining ten countries have made such little progress that EU Tax Commissioner Moscovici, an FTT proponent, responded on February 21, 2019 to a question regarding the status of his FTT proposal by stating that "it is not really in great shape." https://diievents.dii.eu/finance-summit/ (at 28 minutes and 30 seconds). Because of these difficulties, German Finance Minister Scholz recently proposed a much narrower FTT (similar to the French FTT); no agreement has been reached on this proposal or how the tax revenues would be allocated among the participating countries.

For these reasons, FTTs long have faced strong bipartisan opposition

- During the Obama Administration's first term, Treasury Secretary Tim Geithner said: "I have not seen the version of [the FTT] that I think works. . . . There's a real risk that retail investors, who've got fewer choices, they end up bearing the cost of the tax." *Bloomberg*, 12/5/2009

- In the Administration's second term, Treasury Secretary Jack Lew said "The administration has consistently opposed a financial transaction tax on the grounds that it would be vulnerable to evasion, create incentives for financial reengineering and burden retail investors." *Reuters*, 2/25/2013