INVESTMENT COMPANY INSTITUTE

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

April 3, 2019

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 a 0.1-percent rate (10 basis points) under the Wall Street Tax Act of 2019—typically would be applied to the value of the securities transferred. The proposed FTT includes an exception only for the initial issuance of securities, certain traded short-term indebtedness, securities lending, and sale-repurchase transactions.

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 and produce a constant drag on shareholder returns because 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 costs.

An FTT also would reduce the market value of any security subject to the tax. Specifically, the expected future impact of the FTT would be embedded into its market value.

Diminished returns make it harder for all 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 fund investors by taxing them when they 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.

The tax also would harm fund investors who make a single fund purchase—that presumably would be an exempt "initial issuance" purchase—because the fund's portfolio is changing constantly.[1] Specifically, the manager must invest new shareholder cash, sell securities to meet shareholder redemptions, and adjust the fund's holdings to maximize investor returns in changing market conditions.

[1] Stock market purchases of shares in ETFs and closed-end funds, moreover, would be taxable in all events as these secondary market purchases are not at "initial issuance."

Shareholders in money market funds would be hit especially hard by an FTT—as it would apply every time they redeem shares to meet their financial obligations. Certain portfolio transactions by these funds also would be taxable—imposing further burden on money market fund investors.

FTTs Impose Tremendous Costs on Fund Investors

Forty-four million US households that own mutual funds, IRAs, or defined contribution plan accounts have annual income of less than $100,000 and 67 million have annual income of less than $200,000. These moderate-income households represent from 58 percent to 89 percent, respectively, of all households that own mutual funds, IRAs, or defined contribution plan accounts. The FTT would represent a substantial burden on these investors.

While a 10-basis-point tax may sound "small," it would have a large effect on investment returns. In 2018, the proposed FTT would have reduced the returns of long-term mutual funds by $23 billion, or 14 basis points, the same effect as a 31-percent increase in the average expense ratio for 401(k) plan participants invested in equity mutual funds, and a 60-percent increase for equity index fund investors. Investors saving for retirement have benefitted tremendously from falling expense ratios; this tax would significantly negate the benefit that reduced costs have had on investment returns.

Money market fund investors would have fared even worse under the proposed FTT, suffering an estimated $20 billion in additional costs due to the tax, a reduction of 71 basis points in return, which would be a substantial hit given current low interest rates. An FTT on money market fund redemptions would be equivalent to a tax on investors who write checks to pay bills.

An FTT would have additional negative effects on investment returns—thereby imposing additional costs on fund investors. Specifically, returns would be impacted by the deterioration in liquidity and market quality.

FTTs Undermine Good Tax Policy

Multiple Layers of Taxation. FTTs can result in fund investors incurring multiple levels of tax. A tax would be owed as the fund puts investors' savings to work in the market, taxed again when the fund sells shares to meet a redemption request, and taxed yet again when the shareholder redeems. Triple taxation is neither inconsequential nor, as a matter of tax policy, fair—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 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 if an FTT provided an express exception for such tax-exempt investors. Tax also would be owed on redemptions by otherwise tax-exempt investors, under the bills introduced in March 2019, because neither includes any exemption for these investors.

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 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. In addition, there will likely be tremendous effort to avoid the tax, reducing the revenue raised by the tax and perhaps increasing, rather than reducing, resources devoted to financial transactions and financial engineering.

After France enacted its FTT in August 2012, for example, 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.[3] 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 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.

The current proposal, in fact, would have even more severe negative effects than FTTs existing in other countries. Specifically, unlike most existing FTTs, the proposed tax would not exempt market

---

[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. See *Skimming the Froth: Early evidence from the French tax*, The Economist, Dec. 15, 2012, available at: http://www.economist.com/news/finance-and-economics/21568433-early-evidence-french-tax-skimming-froth.

[3] See Tom Newton, *France Warns on Use of Derivatives to Evade New Transaction Tax*, Risk Magazine, Nov. 29, 2012, available at: http://www.risk.net/risk-magazine/news/2227784/france-warns-on-use-of-derivatives-to-evade-new-transaction-tax

makers or other liquidity providers, meaning many trades would be taxed twice—once when an intermediary buys shares from an investor and again when another investor later buys the shares from the intermediary. Moreover, the base of the tax is much broader than typical, encompassing not just stocks but also partnership interests, debt, and derivative contracts.

An FTT would degrade the competitiveness of the US capital markets and cause trading to migrate to less costly foreign venues. Consider the European example.

Europe's Painful Experience with FTTs

Some European countries have tried and abandoned FTTs. 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.[4] Burned by the experience, Sweden got rid of its FTT in 1991.

Some European countries have recently enacted FTTs and are relearning old lessons. Consider France, which enacted an FTT in August 2012. French markets experienced immediate declines in trading volume. Collection difficulties with foreign investors also reduced tax receipts. France collected only €250 million in 2012, less than half the projected €530 million. There also is evidence that some firms substituted other European securities for the impacted French shares.[5] The French Finance Ministry already has had to warn that they will "take appropriate measures where needed" to ensure that the FTT isn't bypassed improperly.

In Italy, immediately after the FTT became effective in March 2013, trading in Italian-domiciled stocks declined by 38 percent. Italy's drop-off in trading activity in March was the biggest one month decline in volume on any major European exchange in 2013. Like France, Italy has little to show for suffering this loss of trading activity. Italy expected to collect €1 billion in FTT revenues in 2013, but in the first 10 months realized only €159 million.

Some European FTTs provide numerous exceptions that limit greatly the taxes' application. Consider the examples provided by the United Kingdom, which maintains a 50-basis point Stamp Duty Reserve Tax—a form of securities transfer tax—on purchases of UK listed companies. First, the tax does not apply to bonds. Second, the tax does not apply to "contracts for difference" (CFDs) or futures. Hence, a significant proportion of economic exposure to UK equities pays no tax. Third, exemptions are provided for financial intermediaries trading on UK-recognized exchanges. These exemptions are necessary to prevent tax "cascading" like that present in the new EU proposal; cascading can turn a 10-basis point tax into a tax of 80 basis points or more. Fourth, the 50-basis point tax does not apply to the issuance of shares. Fifth, an exemption is provided for investor redemptions of interests

[4] Stephen Umlauf, *Transaction Taxes and the Behavior of the Swedish Stock Market,* Journal of Financial Economics (1993).
[5] See Newton, supra.

in "collective investment schemes" (which are similar to mutual funds in the United States). Finally, an exemption is provided for repurchases and stock lending transactions.

New European FTT's Failure to Launch

The European Commission's 2011 FTT proposal had unprecedented extraterritorial scope. A fund—organized anywhere in the world—would be taxed each time it bought portfolio securities from or sold such securities to a party resident in a participating member state. For example, a US fund that sells a US government bond to a German bank would itself be liable for the FTT under the European Commission's proposal. A US fund also would be taxed each time one of its individual investors with a permanent address in a participating member state redeemed shares in the US fund. The "small" tax of 10 basis points on each financial institution that is a party to the transaction was estimated to raise €31 billion a year.

If an FTT eventually is adopted by a group of EU countries, it is likely that the tax adopted will be significantly limited compared to the initially proposed tax. There were once indications that the tax could be rolled out in stages, starting with taxation on "shares and some derivatives." This more limited scope resembles several characteristics that are common features of certain long-standing taxes (*e.g.,* the UK stamp duty) and the recently-enacted FTTs in France and Italy.

Even a more pared down version of the FTT proposal has not gained traction, perhaps due to the negative consequences in France and Italy, since it was proposed. 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.