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Proposal to tax transactions is misguided

If punishment is congressman's goal, the average investor, not Wall Street, would pay the price

By Robert N. Gordon

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By seeking to tax stock transactions, legislation introduced recently by Rep. Peter DeFazio, D-Ore., would penalize the innocent at an exorbitant rate.

The congressman's website offers an explanation for the Let Wall Street Pay for the Restoration of Main Street Act:

“[Since] reckless Wall Street speculation brought us to this point, they should be directly responsible for repaying the taxpayers who bailed them out and saved the banks. There is no question that Wall Street can easily bear this tax.”

The problem with Mr. DeFazio's reasoning is that it is the average investor, not Wall Street, who would pay the tax he proposes.

As it stands, the proposal would tax purchases of securities at 0.25% of the value of the shares traded. This would be on top of the existing small fee (0.0025%) levied on all stock transactions to subsidize the Securities and Exchange Commission.
Although 0.25% doesn't sound like much, it is instructive to see the proposed tax in context. As the average price of a share of stock is $40, the tax on the average share would be 10 cents.

That is higher than the average commission charged by securities firms, which is 5 cents per share. Is the tax supposed to exceed the gross income brokers receive for their efforts?

The DeFazio bill also would apply to options transactions, levying a 0.25% tax on the option premium. Futures and other derivatives would be taxed at 0.02% of the total notional amount underlying the contracts.

An S&P 500 futures contract controlling more than $250,000 in stock would carry a $50 transaction tax. Once again, the tax is more than a broker charges in commissions.

Here is an idea: If Congress wants to punish someone or something, shouldn't it punish those activities or securities that actually contributed to the global financial crisis?

Stock investors didn't cause the crisis; excess leverage and sliced-and-diced securities mostly were to blame. So shouldn't a tax be more logically levied on collateralized-mortgage obligations, collateralized-loan obligations or any of the other securitizations and repackagings?

Economist Paul Krugman, in a Nov. 27 Op-Ed column in The New York Times, outlined his support for a transaction tax:

“What about the claim that a financial-transactions tax doesn't address the real problem? It's true that a transactions tax wouldn't have stopped lenders from making bad loans, or gullible investors from buying toxic waste backed by those loans. But bad investments aren't the whole story of the crisis. What made those bad investments catastrophic was the financial system's excessive reliance on short-term money. As Gary Gorton and Andrew Metrick of Yale have shown, by 2007 the U.S. banking system had become crucially dependent on "repo' transactions, in which financial institutions sell assets to investors while promising to buy them back after a short period — often a single day. Losses on subprime mortgages and other assets triggered a banking crisis because they undermined this system — there was a "run on repo.' And a financial-transactions tax, by discouraging reliance on ultrashort-run financing, would have made such a run much less likely. So contrary to what the skeptics say, such a tax would have helped prevent the current crisis — and could help us avoid a future replay.”

Is Mr. Krugman suggesting a transaction tax on overnight repos? A 0.25% tax levied daily on repos would be even more ridiculous than a 0.25% tax on stock trading.

Even if the proposed futures tax of 0.02% were applied, it would add hundreds of basis points in tax to each overnight repo. And if the 0.25% tax were levied on three-month Treasury bills, the tax would be 100 basis points for the year — more than the interest those T-bills currently pay.

If a tax on transactions is to be levied, let it be imposed on the activities and securities actually responsible for the recent financial crisis. And if levied, let the tax rate be such that it doesn't kill the patient in its attempt to cure him.

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