REMAPPING DEBATE
Asking "Why" and "Why Not"

Robin Hood, nearing European victories, still struggling to awaken in the U.S.

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July 30, 2012 — Concerns about the market-destabilizing effect of speculative, "high-frequency" trading, along with a desire to generate more revenue for governmental programs from a financial sector seen as not paying its fair share of taxes, have stirred calls for the imposition, or re-imposition, of a financial transactions tax (FTT) both in Europe and the United States.

> Several countries in the EU, including Germany, France, Italy, and Spain, are expected to enact a joint FTT, perhaps as early as next year.

More popularly known as a Robin Hood tax, most versions of an FTT have proposed imposing a small fee on stock, bond, and derivative transactions (derivatives include, among other things, currency and commodity futures as well as mortgage-backed securities). In Europe, a rate as high as 0.1 percent has been discussed; in the U.S., most proposals call for a lower rate. One of several FTT bills currently pending in Congress is the Wall Street Trading and Speculators Tax Act, authored by Sen. Tom Harkin (D-Iowa) and Rep. Peter DeFazio (D-Ore.). The Harkin-Defazio bill calls for a levy of 0.03 percent on the value of a transaction.

Most experts agree that the FTT would have little impact on average investors. At the Harkin-Defazio rate, for example, an investor would pay $3 for every $10,000 invested.

However, an FTT would deter, at least to some extent, the *volume* of trading, particularly high-frequency trading. This kind of superfast trading didn't meaningfully exist prior to the mid-1990s, but rose by 2008 to capture — and since retain — more than 50 percent of equity trading in the U.S., peaking at over 60 percent in 2009, according to Adam Sussman, director of research at TABB Group, a financial market research firm.

High-frequency trading is typically the province of financial firms that use customized and proprietary computer programs to trade large blocks of shares — sometimes millions of shares at a time — with the intention of reselling them quickily, sometimes only seconds later, rather than holding them as an investment.

The extent to which high-frequency trading would be deterred by an FTT and the desirability of doing so remain in dispute.

Several countries in the EU, including Germany, France, Italy, and Spain, are expected to enact a joint FTT, perhaps as early as next year. France's own version of an FTT will go into effect this August. In England, where there has been a stand-alone FTT (on stock transactions only) since 1986, Conservative Prime Minister David Cameron has aggressively opposed the institution of an EU-wide FTT that would encompass bond and derivatives trading as well. While Cameron has been successful thus far in forestalling English participation in an EU-wide FTT, there appears to be widespread and organized domestic support for a broader FTT.

By contrast, in the U.S., which had an FTT from 1914 until 1966, support for a new FTT has only just begun to grow, with no real political momentum as of yet.

A critical factor: in other countries, even some center-right politicians, like Nicolas Sarkozy and Angela Merkel, have strongly supported an FTT. Here in the U.S., the national Democratic Party has made no effort to embrace such a proposal. Some suggest that the torpor of most Democrats is a function of the influence wielded by the financial sector in the U.S.

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Curbing speculation

Some FTT supporters see a primary goal of the tax as reducing the scope and volume of high-frequency trading. In this view, high-frequency trading contributes to market volatility and diverts capital that could otherwise be used to boost innovation and invest in companies that create jobs.

The reason that an FTT could squelch high-frequency trading, at least in part, is that the profitability of the practice typically depends on traders taking advantage of small and fleeting price discrepancies, as between a single stock's asking price on two different stock exchanges or slight price differences between related products. By engaging in a very high volume of large-block trading and by holding shares or other investments for sometimes as little as milliseconds, high-frequency traders generate significant profits (at the peak in 2008, high-frequency traders yielded net trading profits in the U.S. totaling $8 to 20 billion).

Because per-share profit is generally small, even a modest FTT would cut into, or even eliminate, that profit. The practice would thereby become less attractive to investment banks, independent high-frequency trading firms, and hedge funds.

Some critics of high-frequency trading say these superfast transactions — which scarcely existed 20 years ago — amount to gambling. They point to events on May 6, 2010 as an example of the risk to market stability that high-frequency trading poses.

Late in that trading day, the Dow Jones Industrial Index dropped almost 600 points in just five minutes. (By the end of the trading day, the index had recovered the 600 points it had lost.) The event came to be known as the "Flash Crash." It was triggered by a large sell initiated by a mutual fund. High-frequency computer programs sensed the movement and flooded the market with trades. Human traders realized something was awry but didn't know what, so they just stopped trading. They effectively turned off their computers.

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During the Flash Crash — which lasted mere minutes — some companies' share prices fluctuated wildly. Accenture, for example, came down from $41 per share to one penny, only to rebound within a few seconds to approximately $40 per share. Procter & Gamble fell from $60 per share to about $39 in the span of 3.5 minutes. And one minute later the stock had sprung back to just over $60. By day's end the market recovered, but other "mini" flash crashes (see here and here) have followed, notably in the currency and commodities markets.

"A very lightly regulated casino," was how Rep. DeFazio described the current U.S. financial market. "It has very little to do with raising capital to support productive enterprise," he said. "Instead it has just become a place where certifiably smart people with degrees from MIT develop algorithms to game the market, [creating] tremendous volatility — to hell with long-term impacts."

Dean Baker, economist and co-director of the liberal Center for Economic and Policy Research, said there isn't sufficient evidence that an FTT on its own would stop high-frequency speculation, although he thinks the volume of high-frequency trading would be slowed. Instead, he emphasized an FTT's ability to shift investors' priorities.

Baker argued that today's financial markets absorb capital and talent that would otherwise be deployed in other areas. If high-frequency trading were to decrease, "you free up labor, you free up capital," he said. The current financial market "pulls away resources from the productive economy. It hurts industries that have a high dependence on external funding," such as new companies looking to grow and innovate. Those firms can have a hard time finding investors, Baker said, because "capital is being diverted to the financial sector."

The revenue-generating potential of an FTT

Aside from its impacts on financial markets and investment patterns, an FTT would, according to its proponents, generate much-needed government revenue at a time when both state and federal budgets are under duress. The Harkin-Defazio bill is projected to raise $352 billion over a nine-year period. Another plan — this one put forward by Robert Pollin, professor of economics and co-director of the

Political Economy Research Institute at the University of Massachusetts-Amherst, and the Institute's associate director, U. Mass. associate research professor James Heintz — claims to be able to raise a comparable amount of money in a single year. The Pollin-Heintz plan would feature rates that vary by type of finanical instrument, imposing the higher rate on stocks transactions (see bottom box).

"We're going to raise $35 billion dollars a year," explained DeFazio, citing revenues generated if his proposed tax were enacted. "We could use [that revenue] to pay the damage caused by Wall Street. We could invest it productively to put people back to work; invest it in our crumbling infrastructure," he explained. "There's something to turn to people and say, 'This raises money, we need money, and this is a benign way of raising money — unlike raising taxes on middle class Americans.'"

Differing rate structures; differing levels of revenue

The amount of money an FTT could generate depends, of course, on what is taxed and at what rate.

The Harkin-DeFazio bill calls for a flat 0.03 percent tax on stocks, bonds, and derivatives. According to a press release from Harkin's and DeFazio's offices, the Joint Committee on Taxation has calculated that the measure would generate revenue of $352 billion from 2013 to 2021.

Robert Pollin and James Heintz, economists at the University of Massachusetts-Amherst, have formulated a very different FTT. Their plan proposes tiered rates of 0.5 percent for stock transactions, 0.15 for those involving bonds, and 0.005 for those involving derivatives.

Similarly, Dean Baker of the Center for Economic and Policy Research has proposed an FTT that would tax stock transactions at a 0.5 percent rate, and both bond and derivative transactions at a 0.01 percent rate.

Some critics dismiss an FTT's revenue-raising potential. They point out that if an FTT successfully discourages high-frequency trading, then there will be fewer transactions to tax. Pollin, Heintz, and Baker all agree that an FTT *will* discourage some trading, particularly high-frequency trading.

Nevertheless, Pollin and Heintz contemplated a 50 percent drop in overall volume when estimating that their FTT would generate $352 billion annually.

When Baker calculated a 50 percent drop from the current trading volume level (the scope and price of derivatives transactions is anything but transparent, so different analysts posit different current transactional volume and cost), he estimated that his proposed rates would yield $177 billion annually.

The U.S. arm of the Robin Hood Tax campaign, an international coalition calling for a global FTT, proposes funding for housing, education, and health care among the projects it believes an FTT could support. Robin Hood campaigners also look to channel funds to provide assistance internationally. For example, "to set ourselves on a course to actually end the global AIDS pandemic, we're talking about needing an extra $10 billion," said Matthew Kavanagh, spokesperson for the Robin Hood campaign's U.S. branch.

> The financial market in the U.S. "pulls away resources from the productive economy," said Dean Baker. If high-frequency trading were to decrease, "you free up labor, you free up capital."

Other FTT proponents have similar goals, albeit with a narrower focus. DeFazio would like to invest the funds for job creation. But he would also like to employ some of the revenue to "defray the deficit." This latter point is controversial among many FTT supporters, including the National Nurses United, a union heavily involved in the Robin Hood campaign. "We don't want this revenue to just pay back bondholders," said Michael Lighty, director of public policy at the union. "We want it to actually develop our communities in a new way."

Easier to administer than sales tax?

In the U.S., implementation of the tax could be straightforward. According to Pollin of U. Mass.-Amherst, "The basics are very, very simple if you think of it as the equivalent of a sales tax." An FTT could be added onto the sale of a security the way a sales tax is added at the cash register when anyone buys furniture, clothes, a car, or other consumer goods. If a broker or an exchange, such as the New York Stock Exchange or the Chicago Mercantile Exchange, were involved in a transaction, the broker or exchange would collect the tax.

Some transactions, especially derivatives, don't involve a broker or an exchange. These "over-the-counter" transactions, often involving banks, hedge funds, or other large investors, would be self-reported, in the manner that businesses self-report the sales taxes they owe.

Critics have said an FTT would be too complicated to monitor, but Pollin disagreed. "It's even less of a problem than keeping track of a sales tax," he said. "Financial transactions are traded electronically, and [are] heavily documented."

Fervent opposition in the U.S.

A principal claim of FTT detractors is that the tax would in fact *succeed* at restraining high-speed trading, and that would damage the economy by rendering markets less liquid.

James Angel, an economist and professor of finance at Georgetown University is an outspoken critic of an FTT. He told Remapping Debate that by discouraging superfast trading, the tax would *increase* volatility in those markets, which would in turn undermine confidence.

Some FTT critics have suggested that these increased transaction costs would apply to a wider range of transactions than advertised, including bank accounts and car loans. “These [transactions] are exempt from the tax,” said DeFazio. “That’s just misleading.” (Other exclusions from coverage under the Harkin-DeFazio bill include notes, bonds, and similar instruments that have a fixed maturity of not more than 100 days, meaning that instruments like short-term Treasuries and commercial paper would not be subject to the tax.)

James Angel, an economist and professor of finance at Georgetown University argues that high-frequency trading promotes market stability, but acknowledges that the necessary price adjustments would occur even in its absence: “It won’t be as efficient, but you’ll get there,” he said.

And all critics of an FTT, including Angel and R. Glenn Hubbard, dean of the Columbia Business School and an economic advisor to Mitt Romney, have said that the costs of the tax will be passed from brokers on to individual investors. They warn that the tax would pose a significant burden on average Americans.

It is true that increased transaction costs could be passed along to consumers. Using the Harkin-DeFazio rate of 0.03 percent, and assuming the consumer carried the full FTT cost, the Center for Economic and Policy Research calculated that a worker with $60,000 in her 401K would pay about $18 per year.

The CBO noted that the risk of capital flight “would be mitigated if other financial centers introduced their own transaction taxes.”

Put another way, there are a variety of investment strategies that don’t utilize high-frequency trading. If one such strategy currently yields 4 percent, that strategy would still yield 3.97 percent if there were an FTT and all costs were passed on to consumers. That’s because these other types of investments don’t rely on generating tiny margins for ultra-short holding periods — the tiny margins that would be wiped out or seriously impaired by an FTT.

Richard Bender, a senior legislative assistant to Sen. Harkin who helped draft the Wall Street Trading and Speculators Tax Act, thinks this wouldn’t be overly burdensome on average investors. “You’re not going to act or not act based on those figures,” he said.

Brighter prospects in Europe

There are critics of an FTT in Europe, too, but such a tax seems on track to be enacted in several countries. Just last month at the latest EU summit, Angela Merkel, the conservative chancellor of Germany, led calls for a financial transaction tax across Europe. Newly elected French president François Hollande also urged fellow states to join. As a result, a growing group, led by Germany, France, Italy, and Spain — with the support of domestic liberal, center-right, and even far-right parties — could enact a financial transaction tax as early as next year.

> Angela Merkel, Germany's center-right chancellor, has said: "We all agree that a financial transaction tax would be the right signal to show that we have understood that financial markets have to contribute their share to the recovery of economies."

Like the Harkin-DeFazio bill, the EU tax would cover stocks, bonds, and derivatives. The rate that is currently being discussed is 0.1 percent for stocks and bonds, and 0.01 for derivatives. The European Commission has estimated that if such an FTT were in place in all 27 member countries it would raise €57 billion annually, or almost $70 billion.

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But the AFL-CIO isn't holding press conferences or spurring its larger membership to action, and many Democratic politicians have remained on the sidelines in the fight for an FTT. Fewer than half of all Democratic members of the House have co-sponsored any of the several bills that have an FTT provision.

Even less support is visible in the Senate, where just three others — Democrats Sheldon Whitehouse from Rhode Island, and Sherrod Brown of Ohio, and Independent Bernie Sanders of Vermont — have sponsored or co-sponsored any FTT legislation.

What about other Democrats? The website of Sen. Kirsten Gillibrand (D-N.Y.), for example, says that she is interested in reforming Wall Street, in keeping New York the "financial capital of the world," and in seeing that the government make "aggressive investments in infrastructure."

We wanted to speak with Sen. Gillibrand regarding her thoughts as to whether an FTT would enhance market stability, redirect financial resources to more productive investments, and help raise revenues that could be applied to funding infrastructure improvements. Her office did not respond to repeated requests.

Gillibrand also did not respond to follow-on emailed questions, including questions asking whether she believed that high-frequency trading posed any problem, why she hasn't supported any FTT, whether she believed that an FTT rate of three-hundredths of one percent (the Harkin-DeFazio rate) would be unduly burdensome, and whether the existing system of fees on stock transactions used to fund the Securities and Exchange Commission suggests that an FTT could be administered effectively.

Rep. DeFazio has ideas about why his fellow party members are reticent to support an FTT. "Democrats don't want to make [Wall Street] too angry," he said. He was speaking from experience. In his most recent reelection campaign in 2010, DeFazio faced a storm of negative ads paid for by a super PAC called Concerned Taxpayers of America. The organization was co-founded just two months before the election by Robert Mercer, the co-chief executive officer of Renaissance Technologies, a high-frequency trading pioneer.

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Though DeFazio ultimately won, other members of Congress got the message. "I've had people say to me, 'Oh [an FTT is] a great idea; sounds interesting,'" DeFazio recounted. "'Yeah, you made some good arguments [for it] — and aren't you the one who had the guy from Wall Street who spent [hundreds of thousands of dollars] against him?'"

DeFazio expressed disappointment that Barack Obama hasn't made an FTT part of his campaign platform. "Where's the president?" he asked. DeFazio was referring to the fact that Obama, like most of the rest of his party, has remained silent on the issue.

"It's still early days" in the U.S., said the Robin Hood spokesperson, Matthew Kavanagh, who is also director of U.S. advocacy at Health GAP. He pointed to the European countries that are taking up the FTT. "At this point there's a key set of willing allies that are moving ahead boldly with an FTT," he said. "That gives us the best example to say, 'Look, this is not pie in the sky. It's not some crazy idea. It's not something that is going to wreck the market.'"

So far, about 70 organizations in the U.S. have joined the Robin Hood campaign.

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