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Why Taxing Stock Trades Is a Really Bad Idea

By Donald L. Luskin and Chris Hynes

The Democrat-dominated Congress has come up with a new way for President Obama to violate his campaign pledge to not raise taxes on families earning less than $250,000 per year. It's a tax on securities transactions—trading in stocks, options, futures and so on.

And why not single out trading for special taxation? We levy special taxes on tobacco, alcohol and other vices. Except that trading isn't a vice. The exchange and hedging of business interests is a virtuous—and utterly essential—activity in a free economy.

But you'd never know it from the angry anticapitalist rhetoric of the tax's proponents. Rep. Peter DeFazio (D., Ore.), who introduced the House bill establishing the tax, positions it as retribution for "the Bush administration's cowboy capitalism, markets know best, deregulation at all cost policies." Sen. Tom Harkin (D., Iowa), who introduced a similar Senate bill, says, "We need a shift in priorities in this country to ask not what America can do for Wall Street, but ask what Wall Street can do for America."

Are you just an ordinary American who trades stocks? You probably don't think of yourself as having much to do with "Wall Street," or of your trading as a vice that ought to be singled out for a special tax. And you surely don't think of yourself as someone who caused the recent financial crisis, which was, as Rep. DeFazio says, "brought on by reckless speculation in the financial markets."

If anything, you probably think of yourself as a casualty of the crisis, not its cause. Why should a stock market investor like you—or for that matter, even an investor literally on Wall Street—pay a tax as punishment for a crime of which you were the victim, not the perpetrator? The crisis was caused by excesses in the mortgage industry, led by government-sponsored entities such as Fannie Mae and Freddie Mac. How did stock transactions—or transactions in options or futures—have anything to do with this crisis?

The proposed tax would apply to commodity transactions as well. So here we find another class of victims being punished. When excesses in the mortgage market blew up the world economy in 2008, commodity investors were hammered as prices plunged in everything from crude oil to gold to corn. Many of them were ordinary businesses—far from Wall Street—trying to hedge themselves against the rising cost of energy.

To be fair, the tax would apply to credit default swaps, which were closely associated with the excesses in mortgage speculation. But if it's going to apply to stocks—which had nothing to do with the crisis except to be its victim—then why does the tax, as proposed by Rep. DeFazio, not apply to bonds? It was the bond market, not the stock market, that was the conduit for hundreds of billions of dollars of dodgy subprime mortgages. Could this possibly be related to the need for the federal government to issue Treasury bonds from here to eternity to finance the looming deficits from the cornucopia of programs being cooked up in Congress?

Setting aside the critical issue of why certain types of securities are singled out for tax, and others are not, the tax as currently proposed does not even succeed in fairly targeting speculators as opposed to investors. In fact, like most tax schemes, it is riddled with arbitrariness and capriciousness.

Suppose you buy a stock, and you hold the position for 20 years. You're an investor. Suppose the person who sold it to you was a day trader—who might end up buying the stock again 10 minutes later from someone else and then selling it after an hour. You both pay the same tax.

As proposed, you wouldn't have to pay a tax to buy or sell mutual funds. Yet mutual funds themselves would have to pay the tax on any trades they make in stocks. So as the owner of the mutual fund, you still end up paying the tax. According to the Investment Company Institute, the average turnover for stock-market mutual funds in 2008 was 60%, which would add up to a lot of taxes.

Transactions in retirement accounts would be exempted. So a corporation that invests to provide pensions to retired workers won't face higher costs. But a retired individual who has just sold his business and is living off the invested proceeds will pay the tax.

And don't believe the proponents of the tax when the say it's so small you'll never notice it. At one quarter of 1%, that would be a cost of $0.33 on a share of IBM. If you were to buy or sell $100,000 worth of IBM (or any stock), the tax would be $250. Single taxpayers would get an annual exemption of that amount. But trade again, and you're taxed $250. Again, another $250. Over and over. Each time, that's about 20 times the commission that a typical online broker would charge you to make that trade -- yes, the greedy broker, the one on Wall Street.

More fundamentally, the proponents of the tax seem not to have thought through what effects it might have on America's global competitive position as the world's pre-eminent stock market. They simply wave away any concern with a flourish of moral indignation. Last summer, when Britain's Financial Services Authority Chairman Adair Turner proposed a trading tax for the United Kingdom, and set in motion a global movement toward such a tax, <a href="http://www.guardian.co.uk/business/2009/aug/27/fsa-bonus-city-banks-tax">he called trading "socially useless."

We shouldn't have to "socially" justify any lawful activity. But surely it is "socially useful" to let free people transact freely, without regulators and legislators micromanaging them. If anything, given the spectacular failure of every regulatory authority and legislator to detect and deter the abuses in mortgage markets that led to a near-meltdown of the global economy, it is their activities that would appear to be "socially useless" and deserving of a special tax.

It's Economics 101 that the free actions of market participants cause supply and demand to reach equilibrium. And isn't that what investors—indeed, even speculators—do? Don't they try to buy things they think are cheap and sell things they think are expensive? Can they do it as well when facing the dead-weight costs of a transaction tax?

If not, then trading volume in our stock markets will fall. Beyond the tax, everyone—investor and speculator, great and small—who buys or sells stocks will pay more to transact in markets that are less liquid. And they will transact at prices that are not set as efficiently. In such a world, markets would necessarily be more risky, and the cost of capital for business would necessarily rise. The consequence of that is that innovation, growth and jobs would necessarily fall. That would be the full and true cost of the trading tax being proposed.

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