

HR 4191: Probably Dangerous and Destructive, But Perhaps Merely Useless

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Oregon Representative Peter DeFazio and others have introduced HR 4191, *Let Wall Street Pay for the Restoration of Main Street Act of 2009*. This bill seeks to fund spending programs by taxing securities and derivatives transactions. As a claimed side benefit in addition to raising revenue, the tax would massively raise the costs of trading, thus curbing “speculation.” But alas, passage of this Act would likely hit the superfecta of unintended consequences as little tax is actually collected, stock prices fall, systemic risks increase, liquidity dries up, and, ironically, credit costs to businesses and individuals rise as banks’ balance sheet capacity gets consumed with favorably taxed-transactions.

The Act, a 0.25% transactions tax, states that it “has a negligible impact on the average investor ” and its sponsors claim that it “will ensure Wall Street pay for needed investment.” Both assertions are false. The sponsors believe that their tax would raise as much as \$150 billion per year. Instead, it would raise only a small fraction of that as trading volume diminishes or alters form to reduce the burden. While that drizzle of revenue might ultimately prove to be embarrassing to the sponsors who promised a downpour of cash, the economic costs will be a tsunami to investors saving for the future, businesses raising capital to expand and create jobs, and to banks working to prevent a further contraction in lending.

Once imposed, the tax either “works” and becomes more aptly titled the *Let Main Street Pay For the Restoration of Main Street Act of 2009* or, more likely, doesn’t work and becomes the *Let No One Pay for the Restoration of Main Street Act of 2009*. Which way it goes will be determined by the precise language of the final Bill, but either direction is a wrong turn for taxpayers and investors.

The UK has had a similar tax for some time. In contrast to the DeFazio proposal, the 0.50% UK Stamp Duty Reserve Tax exempts dealers. This exemption leads to a simple device that miraculously eliminates most of the potential for tax collection and its adverse consequences; investors, both large and small, purchase economic exposure to stock through derivatives trades with dealers. The dealers retain the actual legal ownership of the shares and investors buy the returns from them. To anyone interested in the democratization of corporate governance, forget about it in this case as the investors owning the returns no longer own the shares.

An unfortunate side-effect is it moves a huge volume of assets onto dealer balance sheets, something we won’t be too happy about when the next financial crisis arrives. As bad as

2008 was, imagine if one of the few well-functioning markets at the time, the stock market, all of a sudden also came to crisis because so many customer positions were actually carried on the books of a handful of troubled firms.

All of that seems pretty unwelcome and not at all what the Bill's sponsors intend, so maybe they will not and add a UK-style dealer exemption. Perhaps they also will close off other ways to avoid paying the tax. In that case, investors either pay it or substantially stop trading. If, for some reason, investors are willing to keep on trading a lot and pay a lot of tax, then one thing has to happen – stock prices will fall, a lot. Why? Because the transaction tax imposes a tax on the value of the assets, it gets paid out of the cash flows from the underlying securities. One simple result is that stock prices adjust downward to reflect much of the expected present value of the future stream of taxes. If such a tax were really to generate \$150 billion per year, and that cost was evenly distributed amongst investors (it's hard to predict that but it has to come from somewhere), that value destruction might be in excess of \$1 trillion in the \$13 trillion US equity market. It is doubtful that the bill's supporters intend to drive down stock prices, particularly nowadays, though that's why the consequences are called "unintended." In fact, their discussion implies they think Wall Street will bear all the costs and this is simply false.

The transaction tax is a tax on investors, not bankers. Even if some investors (e.g. mutual funds, and tax-advantaged savings accounts) are exempted from paying the tax, all investors will pay in the form of lower share prices. Notice that nowhere in this process are bank profits taxed, and banker compensation is only hurt by hurting their business, probably not the objective of any of HR 4191's sponsors. Instead, Main Street will see lower pension fund values, both in their own retirement savings and in the public employee pension plans they will now have to top off with new taxes on their homes and incomes.

It's highly likely that far less than \$150 billion per year in tax actually will be paid as trading volumes decline sharply. So the Bill becomes ineffective at raising revenue, but the good news in this case is that share prices will decline less. Trades still will happen, some tax will be paid, and share prices still will fall some. However, the bad news is that a host of side effects will be significant and all dangerous. Trading costs will soar as market making activity is taxed to near extinction. Bid/ask spreads will widen substantially. When an investor wants to sell, there will be fewer market makers to intermediate between him and a future buyer of the same stock. Instead, sellers will have to coax buyers into trading immediately by offering a healthy discount. We will turn our very liquid stock market into an illiquid or at least far less liquid one, to our collective regret. Anyone remember 2008 and the destructive power of illiquid markets?

The problems above are symptoms of a market getting less efficient. Here is another one, volatility will rise, too. How could it not? Without liquidity providers, buyers and sellers have to act more aggressively to find trading partners, so we will see prices jump around more than we do today. And the speculators? Well, they aren't the ones who trade a lot, it's the liquidity providers who do. Will the 0.25% tax prevent a speculator from buying

the \$50 stock that the Internet chat room says will soon trade at \$100? No, but serious investors will be deterred and market prices will become less efficient. We will be paying for that either in the next bubble or the crash that follows it as Mom and Pop buy grossly overpriced shares then sell them at the bottom in an implosion that should never have happened.

The sponsors and some commentators like the tax as a means to eliminate “high-volume short –term speculative trading.” And, yes, the tax would likely put high frequency traders out of business. The problem is that these are today’s market makers, our liquidity providers now that the older, traditional (and ironically more expensive) ones on Wall Street are largely gone. High frequency traders run relatively low risk businesses that serve a needed role in our markets, but they aren’t speculators.

Others like the tax because they hope it will reduce trading done by what academics call “noise traders” and who you might call traditional money managers. A transactions tax would presumably reduce the trading of those who aren’t very good, but it also would reduce the trading of those who are and whose trades are necessary to make prices reflect economic reality. In fact, if noise traders exist it’s highly likely they are “overconfident” and one could easily imagine their trading falling considerably less than their better informed cousins.

Should Congress and the President find enough appeal in HR 4191 to enact it, there are three possible outcomes. The first is that there are enough loopholes that the tax raises little money but has unfortunate side effects like driving jobs and tax revenues overseas or inflating the balance sheets of banks. The second is that there are no meaningful loopholes but, surprisingly, people still trade a lot and enormous taxes are paid, in which case we expect stock prices to fall dramatically. The third, and most likely, is that there aren’t enough exemptions and investors react by sharply reducing trading activity, so there is little revenue but great harm to the market and the economy. Whichever of these occurs, the sponsors of the Bill will face a hard time explaining how, when aiming to shoot the banks, they shot their constituents who will then pay for the next Wall Street bailout.

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