MERCATUS CENTER
George Mason University

3434 WASHINGTON BLVD.
4TH FLOOR
ARLINGTON, VA 22201

PHONE: 703.993.4930 / 800.815.5711
FAX: 703.993.4935
WWW.MERCATUS.ORG

From the Desk of Andrew N. Vollmer

April 16, 2021

Mr. Cameron Ricker
Chief Clerk
US Senate Committee on Banking, Housing, and Urban Affairs

Re: Hearing on March 9, 2021 entitled "Who Wins on Wall Street? GameStop, Robinhood, and the State of Retail Investing"

Dear Mr. Ricker,

After my testimony before the Committee on March 9, 2021, Chairman Brown requested answers to three questions submitted by Senator Daines. The questions and answers are below.

> **(1) Many of my colleagues across the aisle have recently spoken in favor of implementing a Financial Transaction Tax (FTT). They argue that doing so is necessary in order to reduce market volatility and make sure that Wall Street is paying its fair share. However, given that data from the Federal Reserve shows that 53% of US families owned some form of publicly traded stock in 2019 and that 80-100 million Americans have a 401k, what impact would the imposition of a FTT have on pensioners and retail investors?**

The idea of an FTT is hotly debated. Supporters argue that an FTT would raise revenue for the government, reduce trading in securities, especially by high frequency traders, fall more on the wealthy than on middle- and low-income people, and therefore reduce the gap between the wealthy and less wealthy.[1] Opponents argue that an FTT would be harmful.[2] Extensive academic literature on FTTs exists.[3] Scholars for the Mercatus Center have contributed to this literature.[4]

[1] Naomi Jagoda, "Financial Trade Tax Gains Traction with 2020 Democrats," *The Hill*, February 25, 2020.
[2] SIFMA, *A Financial Transaction Tax Is a Retirement Tax Which Harms Working Americans, the U.S. Capital Markets and Individual Investors*, 2019.
[3] See, for example, Jean-Edouard Colliard and Peter Hoffmann, "Financial Transaction Taxes, Market Composition, and Liquidity," *Journal of Finance* 72, no. 6 (2017): 2685–2716. Further studies are cited in Leonard E. Burman et al., "Financial Transaction Taxes in Theory and Practice," *National Tax Journal* 69, no. 1 (2016): 171–216; and George H. K. Wang and Jot Yau, "Would a Financial Transaction Tax Affect Financial Market Activity?" (Policy Analysis No. 702, Cato Institute, Washington, DC, July 9, 2012).
[4] Phillip Swagel and Cynthia Boruchowicz, "Policies to Address Income Inequality and Increase Economic Opportunities for Low-Income Families" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, May 2017), 26–27; Holly A. Bell, "Using the Market to Manage Proprietary Algorithmic Trading," in *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*, ed. Hester Peirce and Benjamin Klutsey (Arlington, VA: Mercatus Center at George Mason University, 2016), 262–65; George H. K. Wang, "Securities Transaction Taxes and Market Quality of Equity and Futures Markets: Issues and Evidence" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, March 2014).

The cost of an FTT would fall on both professional investors and individual investors. An FTT would reduce the net returns of retail investors and retirees who have mutual funds or retirement funds because retirement plans and mutual funds buy and sell securities, which are transactions that would be subject to the tax. Writers dispute the amount of the cost to individuals with retirement accounts or mutual funds.[5]

Financial economists do not agree on all the effects of an FTT. They do tend to agree that a tax would reduce the volume of securities trading and would not produce as much revenue as expected.[6] Some analysts claim that an FTT could cause riskier investments or more price volatility.[7] It might be fair to say that the tax would alter securities trading behavior in unexpected and unintended ways.

Supporters of an FTT believe that it will discourage high-frequency trading (HFT).[8] Neither Congress nor the staff of the SEC have concluded that HFT should be discouraged. As late as 2018, Congress had not determined that HFT causes undue harms that needed to be regulated and instead was keeping its policy options open while collecting further evidence. In legislation, Congress instructed the SEC staff to prepare a report assessing the benefits and risks of algorithmic trading to equity and debt markets and recommending necessary changes to federal regulation.[9] (For practical purposes, algorithmic trading is another term for HFT.)

The SEC staff delivered the requested report in early August 2020 but did not recommend any additional regulation to curtail HFT activities.[10] In fact, the staff did not conclude that harms from HFT outweigh the benefits and, if anything, dwelled more on the benefits. Algorithmic trading in the equities markets, the staff wrote, "has improved many measures of market quality and liquidity provision during normal market conditions, though studies have also shown that some types of algorithmic trading may exacerbate periods of unusual market stress or volatility."[11] In addition, the SEC staff discerned that algorithms help market participants reduce risks from the increasing complexity of many interconnected markets.[12]

The staff also surveyed the academic literature and concluded that, "Overall, most academic studies find that algorithmic trading and HFTs have improved market quality and helped reduce transaction costs. There is ample evidence suggesting that, under normal market conditions, algorithmic trading and HFTs improve liquidity and price efficiency and reduce short term volatility."[13]

---

[5] Michael Edesess, "Vanguard Opposes a Tax on Wall Street Its Founder John Bogle Favored – and the Reason May Surprise You," *MarketWatch*, September 3, 2020. According to Edesess, "The real burden of an FTT will fall on the professional traders." SIFMA, *A Financial Transaction Tax is a Retirement Tax*; Burton G. Malkiel and George U. Sauter, "A Transaction Tax Would Hurt All Investors," *Wall Street Journal*, December 8, 2009. According to Sauter, "'Wall Street' would not foot the bill for the presumed $150 billion tax. In fact, the tax would simply be added to the cost of doing business, burdening all investors, including 401(k) plans, IRAs and mutual funds."
[6] Colin Miller and Anna Tyger, "The Impact of a Financial Transactions Tax" (Fiscal Fact No. 690, Tax Foundation, Washington, DC, January 2020), 1.
[7] Miller and Tyger, "The Impact of a Financial Transactions Tax 1."
[8] Aaron Klein, "What Is a Financial Transaction Tax?," *Voter Vitals*, Brookings Policy, March 27, 2020).
[9] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 § 502, 132 Stat. 1296, 1361–62 (2018).
[10] Staff of the Securities and Exchange Commission, *Staff Report on Algorithmic Trading in U.S. Capital Markets*, August 5, 2020.
[11] Staff of the Securities and Exchange Commission, *Staff Report on Algorithmic Trading in U.S. Capital Markets,* 4.
[12] Staff of the Securities and Exchange Commission, 4.
[13] Staff of the Securities and Exchange Commission, 70 (footnote omitted). According to the report, most studies "find that algorithmic trading and high-frequency trading improve price efficiency and decrease the time it takes for prices to

The staff noted that evidence of the effect of high-speed trading in periods of stress was mixed. At least "some academic studies . . . find that algorithmic trading and high-frequency trading continue to reduce volatility during periods of heightened volatility."[14]

> **(2) If the U.S. were to institute an FTT, would you expect many firms would move their trading operations to an international exchange with a more hospitable tax environment?**

Capital flows freely across international boundaries and seeks the most efficient markets. Adding costs with a new securities tax in the United States inevitably will drive some amount of securities trading to lower-cost jurisdictions. According to economist Aaron Klein, "Several countries attempted large FTTs in the past and experienced significant capital migration."[15]

> **(3) Is it your belief that Congress should actively use the tax code to limit the practice of short selling? And is there any evidence to suggest that imposing an FTT would reduce the prevalence of short selling?**

Short selling is socially valuable. Short sellers help to discover accurate prices and to identify companies that are overvalued or engaged in questionable conduct. Academic studies do not support the claims that short selling causes distress in the securities markets.[16]

Tax and regulatory policy should treat short selling and short covering no better and no worse than long buying and selling. Tax, disclosure, and other obligations should be comparable and not more onerous for short transactions.

If an FTT is applied neutrally and equally to all securities sales and purchases, it would reduce short selling and covering to the same extent as long buying and selling. I am not aware of evidence that an FTT would reduce short sales more than it would reduce other securities transactions. As mentioned earlier, most commentators agree that an FTT would reduce the number of securities transactions.

The main objective of the federal tax system should be to raise revenue to fund Congress's expenditures at the least cost to economic activity. Using tax provisions to encourage or discourage particular types of conduct or to benefit or penalize particular groups or activities leads to

---

incorporate new information." Staff of the Securities and Exchange Commission, *Staff Report on Algorithmic Trading in U.S. Capital Markets*, 77.

[14] Staff of the Securities and Exchange Commission, *Staff Report on Algorithmic Trading in U.S. Capital Markets*, 79.

[15] Klein, "What Is a Financial Transaction Tax?"; Bell, "Using the Market."

[16] For example, see Peter Molk and Frank Partnoy, "The Long-Term Effects of Short Selling and Negative Activism," *University of Illinois Law Review* (forthcoming). See also Ekkehart Boehmer and Juan Wu, "Short Selling and the Price Discovery Process," *Review of Financial Studies* 26, no. 2 (2013): 287–322. The authors state that stock prices are more accurate when short sellers are more active. See also Alessandro Beber and Marco Pagano, "Short-Selling Bans Around the World: Evidence from the 2007-09 Crisis," *Journal of Finance* 68, no. 1 (2013): 343–81. According to Beber and Pagano, bans (a) were detrimental for liquidity, especially for stocks with small market capitalization, high volatility, and no listed options; (b) slowed down price discovery, especially in bear market phases, and (c) failed to support stock prices, except possibly for US financial stocks). See also Pedro A. C. Saffi and Kari Sigurdsson, "Price Efficiency and Short Selling," *Review of Financial Studies* 24, no. 3 (2011): 821–52. Saffi and Sigurdsson report that relaxing short-sales constraints are not associated with an increase in either price instability or the occurrence of extreme negative returns). Finally, see Securities and Exchange Commission, Office of Economic Analysis, *Economic Analysis of the Short Sale Price Restrictions under the Regulation SHO Pilot*, February 6, 2007. This report provides analysis of price restrictions on short sales.

complexity in the law, difficulties in complying with the law, concealed differential treatment, and unforeseen and unpredictable consequences.

Very truly yours,

Andrew N. Vollmer
Senior Affiliated Scholar, Mercatus Center at George Mason University