What a Tax on Wall Street Speculation Can Do for America

Dean Baker, Center for Economic and Policy Research

Simply by clicking computer mice to execute millions of rapid-fire transactions, wealthy U.S. hedge fund managers can rake in more than $1 billion apiece a year. These speculators borrow large amounts of other people's money and use it to make heavily leveraged bets in money markets. With enough leverage and many trades, even small margins on each transaction can add up to very large gains.

Why should we care? Although speculative maneuvers yield enormous windfalls to a few winners, they provide little or no benefit to the entire American economy. Up to a point, a strong financial sector can help a country allocate investments more efficiently, but the United States has passed that point. Our badly bloated financial sector is now a drain on the real economy and is one of the main contributors to rapidly expanding inequalities of wealth and income. Reducing bloat in the over-grown financial sector would both promote real economic growth and help more workers and small investors share in national economic expansion.

There is an easy way to rein in unnecessary financial bloat. A very small tax on financial transactions would have little impact on normal investors, but would raise the cost of rapid-fire speculation and make it less prominent in the U.S. financial industry as a whole. The new revenues would also help reduce the federal budget deficit.

Why Financial Bloat is Wasteful

Over the past several decades, the U.S. sector devoted to trading stocks, bonds, options, and other complex financial instruments has grown more than five times as a portion of the entire U.S. economy. An additional $300 billion more a year is now channeled into this sector.

The growing share of resources going into financial speculation is largely a waste. Finance does not directly increase well-being as, for example, health care and housing do. Finance is an intermediate good, like trucking. Trucking is essential to get goods from producers to consumers, but an efficient trucking industry is small. In the same way, the financial sector plays an essential role in getting money from people who want to save to those who want to borrow. But the best financial sector does its job efficiently, without bloat and without misallocating resources.

According to recent research, an overgrown financial sector hinders overall economic growth, because it pulls money and skilled people away from productive sectors of the economy.

- Sectors of the economy that spend large amounts on research and development – like computers and pharmaceuticals – appear to perform more poorly in countries with bloated financial sectors. Probably, this happens because a speculative financial sector pulls too many highly skilled employees away from working in research and development.

- Fast-growing firms that depend on external financing to support growth (rather than reinvesting retained earnings) appear to be hurt by an overly expansive financial sector – perhaps because too much capital is devoted to speculation rather than investments in innovative production.

How a Transactions Tax Could Help

A simple, proven way to trim a bloated financial sector is with a modest tax on financial transactions. The logic is straightforward. Even a tiny tax eats up much of the margin on many highly leveraged rapid-fire transactions. This creates a disincentive, because speculators who rely on such trading would end up paying substantial tax revenue to the government. At the same time, a small transactions tax would have little effect on ordinary investors, who move money from time to time in search of more efficient, higher-paying opportunities.

A transaction tax would also help reduce the federal budget deficit. For example, a bill currently before Congress would impose a tax of 0.03 percent on most financial transactions. This legislation is sponsored by Iowa Senator Tom Harkin and Oregon Representative Peter DeFazio, and the nonpartisan Joint Tax Committee in Congress has run the numbers to show that it would raise more than $350 billion over the first nine years it was in existence.

Financial trading costs have been falling rapidly over the last three decades as a result of the advance of computer technology. The 0.03 percent tax rate in the Harkin-DeFazio bill would merely raise trading costs back to where they were 5-10 years ago.

Speculators Pay – and the Nation Benefits

The vast majority of the revenue raised by such a tax would come directly from the financial industry, because it is responsible for most trading. Investors in general would respond simply by placing trades less frequently. Research shows that the volume of trading is highly responsive to costs. For example, if a tax (set higher than the actual Harkin-DeFazio proposal) doubled the typical cost of a trade, then most people would cut back trading by roughly 50 percent. In this case a typical trader would pay more for each trade, but carry out fewer trades, leaving their total costs virtually unchanged.

Several of the largest European countries have been pushing for a tax of 0.1 percent on stock trades, coupled with a 0.01 percent rate on options, futures and short-lived derivative instruments. This is substantially higher than the Harkin-DeFazio proposal for the United States. And it is not as if this kind of tax is unproven. For centuries, Great Britain has levied a tax of 0.5 percent that applies only to stocks (not to options, futures or other derivatives). The British tax raises an amount equal to about $30-40 billion a year in U.S. terms – and yet the London stock exchange continues to be one of the largest and most vibrant in the world.

Finance is not an end in itself. With a tax set at the British level and applicable to the full range of trades, the United States could raise about $150 billion a year – and at the same time reduce the bloated dead weight of speculation on our economy. Financial transactions taxes have existed for centuries around the world, and the time has come for America to use this valuable tool as well.

Read more in Dean Baker, "The Benefits of a Financial Transactions Tax," Center for Economic and Policy Research, 2008.