THE WORST TAX HIKE

Treasury Secretary Nicholas Brady and Office of Management and Budget Director Richard Darman seem determined to ignore the economic lessons of the past, particularly those that inflicted grave damage on the American economy. To them applies what Talleyrand said of the Bourbons when they reclaimed the French throne after the French Revolution: "They have learned nothing and forgotten nothing." Only a disregard for the fundamentals of economics can explain the Brady-Darman flirtation with a tax on stock transactions. According to the July 5 *Wall Street Journal*, they are "intrigued by" the idea of a .5 percent tax on all sales of stocks, bonds, futures contracts, and other financial instruments. Brady confirmed just yesterday at the National Press Club that the Administration is considering the measure. Few taxes would do more damage to the economy. Indeed, Darman criticized such a tax in a January 1989 written statement to the Senate Governmental Affairs Committee. Wrote Darman: "A stock transfer tax has no evident justification. It would cause distortions in the financial markets, and could cause many investors, particularly institutions, to shift their equity trading away from organized exchanges and to foreign countries." (OMB refuses to comment on whether Darman stands by this statement.) By punishing securities sales, such a tax would cause an immediate plunge in the stock market and drive many traders out of the United States to foreign exchanges. By lowering the values of all stocks, this tax would erode the wealth and savings of all Americans. And by crippling the stock market, this tax would slow down the economy, which would mean less revenue collected by the federal government and a higher budget deficit. George Bush should loudly and publicly repudiate this worst tax.

Making All Americans Poorer. Stock markets are essential to America's economic growth and prosperity. They provide funds for businesses and opportunities for Americans to invest for the future. A securities transfer tax immediately would lower the value of nearly all stocks. The price a purchaser is willing to pay for a security today depends in large part on her or his expectation of what the security will be worth after taxes when it is sold. If a tax must be paid upon the sale of a stock, the buyer will not be willing to pay as much for the stock in the first place. Therefore, a securities transfer tax would immediately cause a sharp drop in security prices. Indeed, the initial report that such a tax was being considered plunged the Dow Jones Industrial Average 32 points.

What is worse, a securities transfer tax would reduce drastically market liquidity, that is, the ease with which stocks can be converted into cash. Stocks and bonds are highly valued in part because, unlike a house or a business or art, purchasers know that they can readily resell them. A reduction in the overall liquidity of securities markets of course results in a reduction in the values of securities. The tax would not only affect wealthy individuals and corporations. Mainly it would hit pension funds, which invest on behalf of tens of millions of ordinary workers. These funds are among the most active sellers and buyers of securities. Working Americans will end up paying the lion's share of the tax out of their retirement savings.

The prices of stocks and commodities communicate the best current information regarding their immediate demand and their expected future values. New information is processed almost instantaneously by the market in the form of price changes, helping entrepreneurs make decisions on how best to invest their capital. By penalizing trading, a securities transfer tax would impede significantly the introduction of new information into the marketplace. Raising the threshold of trading profitability would mean that information would only be incorporated into prices in large, discrete doses. Investors would wait until enough information had accumulated to make trading worthwhile despite the tax. Prices would adjust only infrequently and in large jumps up or down. This would increase vastly the chances that entrepreneurs would err when they invest.

One supposed advantage of a securities transfer tax is that it would encourage people to hold stocks longer, thereby making investors think more of long-run performance of each company. Yet this view confuses owners with managers. While the proposed tax surely would induce people to hold stocks for longer periods, it simultaneously would prompt corporate managers to focus more on short-term results. The reason: by making it more difficult and costly to raise capital, the tax would discourage such long-term projects as the development of new products or the introduction of more efficient equipment. This is because the longer a firm uses capital, the more it must pay for it. Therefore, a tax that increases capital costs would fall more heavily on long-term projects.

Driving Securities Business Overseas. A reading of even relatively recent history would alert Brady and Darman to one of the least reversible dangers of their tax: decimation of the U.S. securities industry. The securities transfer tax would drive much stock trading overseas. Computer and communications advances enable stocks to be traded just as easily in London or Tokyo or the Cayman Islands as in New York. A tax on trades in the U.S. would drive investors overseas. While the U.S. might attempt to apply the new tax to Americans trading on foreign exchanges, enforcement would be difficult if not impossible. America tried a similar tax in 1963 under President John F. Kennedy; it was the now-notorious one percent Interest Equalization Tax on all foreign borrowing other than by Canadians or Japanese in the U.S. The goal of the tax was to induce foreigners to borrow in currencies other than the dollar. While foreigners did shift their borrowing overseas, they continued to borrow dollars. By using the large volume of dollars already held in Europe they were able to avoid the tax. The tax nonetheless had a consequence: it drove dollar-denominated borrowing overseas, giving birth to the Eurodollar market that to this day competes with the American financial services industry. The Brady-Darman tax would be a gift to the Japanese, British, and other foreign security centers which seek to undermine America's domination of the industry.

The Congressional Budget Office estimates that a securities transfer tax would raise $7.8 billion in its first year and $57.7 billion over five years, which would help to reduce the budget deficit. These figures are seriously flawed. They do not take full account of the reduction in trading activity that such a tax would cause. Nor do they account for the drop in revenues from other taxes. Example: capital gains tax revenues would be reduced as stock prices decline. And, of course, the rosy estimates of new revenues to be raised by this tax ignore completely what would happen to overall U.S. tax collections when, as a result of the securities tax, economic activity would fall, unemployment rise, and security businesses flee American shores for more hospitable environments abroad.

Securities markets are the heart and brain of a capitalist system, providing the funds necessary for economic growth and the information needed for the most efficient allocation of resources. By taxing securities transactions, by making markets less efficient the entire economy is crippled. The President should ignore the current Brady-Darman advice. Instead, he should recall what Darman told the Senate last year and pledge to maintain a growing economy by rejecting this tax.

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