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Short-Sighted Plans For Higher Taxes On Financial Trading Markets

Several provisions in the Clinton budget package would target financial markets. The changes, which are similar to ones put forward by the Bush Administration, would raise the costs of various financial activities — the holding of security inventories by security dealers, the trading of contracts on commodity futures markets, and the use of new security issues to obtain investment funds — thereby creating or worsening tax biases against the affected activities. The proposals would make it more difficult to direct capital to the best uses and tend to reduce the volume of investment compared to what it would otherwise be. They are not justified in terms of sound tax principles. The harmful consequences are inconsistent with the Clinton Administration's claim that its budget plan would be "laying the foundation for long-term economic growth." Moreover, because the Administration fails to recognize the damaging economic consequences of the proposals, it overestimates their revenue-raising ability. Perhaps more threatening than the currently requested tax increases, though, are the precedents they might set for future tax changes.

Mark-to-market inventory valuation for security dealers One provision would require security dealers to value their security inventories (securities held for resale rather than investment purposes) at market prices, not actual costs. Under current tax law, security dealers can value their security inventories at cost, at market value, or at the lower of cost or market value. Forcing dealers to employ the "mark-to-market procedure" would increase their effective tax rates (at least in rising stock and bond markets) by accelerating their tax liabilities. (Collecting taxes sooner raises effective tax rates because, due to the combined effects of inflation and the value of time, $1 now is worth more than $1 in the future.) The Administration estimates that mark-to-market accounting would increase security dealers' taxes by $4.4 billion for fiscal years 1994-1998.

The cost method is a long-standing technique, widely used in many industries, for valuing inventories for tax purposes. Prohibiting its use by security dealers would be a major departure from normal tax practices.

The change would generally increase the tax cost of holding inventories. In addition, by making it harder for security dealers to compute their year-end tax liabilities in advance, it would increase their risk of owing penalties for inadvertently paying too little in estimated taxes. Security dealers would probably respond to the tax-induced higher cost and added risk by trimming their security inventories. Dealers would also tend to carry smaller inventories because effective taxation of unrealized gains would cause a liquidity problem for some, and the most direct means of raising needed cash would be to sell off some holdings.

The additional tax burden would weaken security dealers, important players in financial markets. Perhaps the dealers could pass some of the tax to their customers, but that would only shift the damage to other key financial-market participants. Further, because foreign dealers operating abroad would not be subject to this tax increase, the mark-to-market proposal would hand them a competitive advantage at the expense of U.S. dealers, pushing some security-industry jobs offshore. All of these effects are completely contrary to the Administration's claim that its proposals would bolster the U.S. economy.

The proposed change is discriminatory because it would single out security dealers for punitive changes in inventory tax treatment. The Administration begins

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its list of reasons for the change by saying, "Inventories of marketable securities are easily valued at year end ..." The same thing is true of a wide range of products, but the Administration does not propose making mark-to-market the generally applicable mode of inventory accounting for tax purposes. The Administration also argues that the mark-to-market method should be required because some security dealers use it in their financial statements. But financial statements and tax rules often differ for valid reasons. Tax rules should be guided by the neutrality principle: taxes should not create biases for or against particular activities. The mark-to-market method is bad tax policy because of the tax biases cited above.

The mark-to-market proposal would set a worrisome precedent. A change in inventory valuation rules here could pave the way for similar alterations in other industries. Changing the tax laws to require including unrealized inventory gains in taxable income might well lead to efforts to apply the same punitive treatment to unrealized capital gains of owners of all readily-valued capital assets. That would undo the limited relief provided by the current deferral of tax until realization. Generalized taxation of unrealized capital gains would discourage saving and investment because it would expose investors to liquidity problems, higher tax-compliance costs, more uncertainty, and greater overtaxation of the rewards for saving and investment. Because there is already multiple taxation of the rewards for saving and investment, capital gains should, ideally, not be taxed at all.

Transactions tax on commodities futures exchange trading A second proposal (labelled a "spending cut" by the Administration) would place a fee (apparently 14 or 15 cents per contract) on all U.S. commodity futures and option exchange transactions. According to the Administration, this revenue raiser would bring an "estimated saving" of $301 million for fiscal years 1994-1998.

The Administration says the fee would help defray the costs of the Commodity Futures Trading Commission (CFTC) and calls it a "processing fee", suggesting a corollary with a free-market payment for services rendered. The charge, in fact, would be nothing of the kind; it would be a transactions tax. To have a true users fee, a purchase must be voluntary. Customers must have the option of not buying the product if they do not think it is worth the price. Customers must also have the option of buying the product from competitors if the competitors offer superior quality or lower price. In the free market, threatening potential customers with punishment if they do not buy your product is known as extortion, and preventing them from dealing with competitors is usually called monopolization. With the proposed commodity-exchange tax, free-market options would be forbidden. Futures market participants could not remove themselves from CFTC jurisdiction nor turn to alternative watchdogs, like accounting firms and insurance companies. Those who did not pay the transactions tax would face civil and criminal penalties.

Producers and investors use futures contracts to lock in the prices at which they may buy or sell products at specified future dates. This allows the parties to hedge against market uncertainties and to reallocate market risks among themselves. Futures contracts are also valuable because, by communicating information about expected future supply and demand conditions, they facilitate informed production and consumption decisions. The proposed transaction tax would impair the functioning of the futures market. Although the suggested tax rate would not be high, it would be the proverbial camel's nose under the tent. Any number of taxes have been introduced at low rates and then quickly and dramatically increased through succeeding legislation.

The futures-exchange transaction tax is akin to a stock-transfer tax. If it is imposed, voices will soon be heard urging that it should be extended to stocks, citing the many interconnections between the stock and futures markets. Efforts were made several years ago to enact a stock-transfer tax, and the current proposal would provide a fresh impetus. If the transactions tax were subsequently extended to stocks, it would discourage stock trading by raising the cost of doing so. That would intensify the existing lock-in effect produced by taxing capital gains, reducing the flexibility and efficiency of capital markets. The higher trading costs would also make stocks a less attractive investment vehicle.

The transactions tax would encourage all parties to trade in overseas financial centers, not subject to the

tax, rather than in U.S. financial markets, especially if the levy is raised repeatedly or broadened to cover stocks. With modern communications technology, transactions can be executed virtually anywhere. The Administration admits "this fee may adversely affect the competitiveness of U.S. futures exchanges", but pretends it can "correct for" any problems by giving the CFTC some "discretion" in setting the fee. The basic problem is the proposed tax itself, and the way to correct for that is to refrain from imposing the tax in the first place.

SEC registration fee for securities being sold to the public The Clinton Administration also wishes to increase by a third the fee that corporations must pay to the Securities and Exchange Commission (SEC) when they register securities being offered to the public. The new rate would be 1/24th of 1 percent of the dollar volume of securities being registered with the SEC. The Administration says this "spending cut" would bring an "estimated saving" of $499 million for fiscal years 1994-1998.

As with the CFTC tax, the Clinton Administration insists this is merely a user fee for valuable government services. Again, it is not a true user fee at all because there is nothing voluntary about this tax. Apparently, not even the Administration takes the user fee label seriously: about half of the proposed increase would go straight into the U.S. Treasury's general fund, as does most of the current levy.

Because the security registration tax increases the cost of new-issue financing, it encourages businesses to turn to alternative, less efficient means of financing or to abandon worthwhile ventures altogether. The proposed increase is especially unwarranted because the ink is hardly dry on the last rate hike. If enacted, it would be another obstacle for producers who try to implement their investment plans by raising money from the public.

Given the Clinton Administration's many statements on the importance of fostering investment, it should follow policies exactly contrary to what it has recommended. The Administration should seek neither heavier taxation of security dealers' inventories nor a new tax on commodity futures and options contracts. And instead of trying to increase the SEC tax on security registrations, the Administration should urge a reduction in that tax. Financial markets are extremely important in directing saving into the most valuable investment projects. By obstructing those flows, the proposed taxes, and the future levies they may encourage, would decrease saving and investment and diminish the likelihood that good investment ideas will be translated into action.

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