Chicago Political Economy Group

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Illinois and Chicago Need a LaSalle Street Tax (LST) Now! : Follow-up on June 7, 2016 Legislative Hearing Presentation

1) From slide 7 of my edited hearing presentation now up on CPEG cite (see: http://www.cpegonline.org/2016/06/20/cpeg-to-illinois-legislature-lasalle-street-tax-now/ for Baiman and Barclay testimony power point links) :
    a. Derivatives are bets that can only be placed in very large dollar values. On average $73,725 for Ag contracts and $376,848 for Non-Ag contracts.
    b. Traders put up a 2%-5% "margin" of these notional values to borrow the funds to place their bet (2% of average contract notional values, above, is $148 - $671).
    c. As Traders are betting against each other the average of gains and losses of all derivative bets at any point in time is zero (minus transaction fees paid the exchanges).
    d. Non-speculative traders who use derivatives to hedge risks are not going to care about a $1 or $2 fee on a ten, or hundreds of, thousands of dollars hedge.
    e. The small average $0.37 to $0.75 profit per contract estimate for HFT traders is an average of wins and losses of changes (minimum "tick" $ 6.25 – see Barclay presentation) in the notional values above.
    f. An LST cannot be applied to average HFT profits (or corresponding negative non-HFT average losses) as the net of this "capital gains" tax would be zero - or actually negative taking into account exchange fees. So CME CEO Duffy's implication that LST applies to trading profit or loss (the source of the 800% tax figure) makes no sense.
    g. Concerns about an LST repressing HFT trading can best be addressed by linking the fee level to contract holding time, not by reducing the fee.

2) In other words, the consistent small positive average profit per contract (averaged over millions of much larger contract gains and losses) for HFT's cited in the literature, has to be offset by a small negative average profit per contract for their counter-party non-HFT traders. So all the numbers cited, $0.35, $30.00, or whatever, make no sense *unless they apply to a subset of traders who consistently beat the odds* like HFT traders. We're proposing to apply a very small excise fee to very large bets. Some of the gamblers (HFT traders) whose motivation is purely speculative who according to academic estimates now average $0.37 to $0.75 per contract on millions of contracts, will not make as much money as they were without this fee. But the fact is that consistently positive profits made by HFT traders have to be matched by consistently negative losses by non-HFT traders, so repressing HFT trading should benefit non-HFT "economic traders".

3) Successful HFT's consistently (on a daily basis) make positive average profits over millions of trades by exploiting nanosecond differentials in pricing or information about prices (which they acquire slightly earlier than other traders), and by gaming the markets.

For example, by using multiple rapidly placed, small, or unfulfilled bids (illegal "wash" trades), that discover, or move market prices, followed by larger actual trades to quickly exploit small pricing differentials . Non-speculative traders using the markets to hedge risk don't realize that they could have gotten better deals without HFT traders skimming off profits (and as they're hedging tens and hundreds of thousands of dollars of risk they wouldn't care about an extra $1 or $2 fee). The motivation for non-HFT speculative traders is that when you win, you can win really big. If you're an HFT trader making millions of computerized trades, you're more after consistent average per contract winnings than very large, but less frequent, jack pots. Trading millions of contracts a day, and consistently making positive profit per contract, and an overall average of $0.37 to $0.75 per contract, equals big profits for HFT traders.

4) To put all this is perspective Taiwan has successfully applied a financial transactions tax (FTT) since 1965. In 2008 the Taiwan FTT supplied $ 3 B in revenue, 5.5% of total tax revenue received by the government of Taiwan. Rates for different trading products have been adjusted over the years. In 2010 (see: http://www.robinhoodtax.org/sites/default/files/Raising%2520Revenue%2520web.pdf) the rates applied to derivatives was between 0.0000125 and 0.06 of a percent of the notional value of the contract, for futures contracts (see p. 6 of link above). Based on average values of Ag and Non-Ag contracts to which the CPEG LST would apply (see slide 8 of Baiman CPEG testimony link above), applying a Taiwan FTT to these values would result in the average LST per contract fees shown in Figure 1 below:

Figure 1: Per Contract LST Set at Taiwan Futures Contract FTT Levels			
		Lowest % Rate	Highest % Rate
		0.0000125%	0.06%
Avg Non-Ag Contract Value	$335,719	$0.04	$201.43
Avg Ag Contract Value	$73,725	$0.01	$44.24
Avg Contract Value	$285,957	$0.04	$171.57

However, as average futures contract values in the Taiwan exchange probably differ from the Chicago Exchanges, a more useful comparison might be to calculate effective LST tax rates on average contract values that match the $1 and $2 fees of the LST proposal, see Figure 2 below (based on sources for Figure 1):

Figure 2: LST Proposal Average Rate		
		Average % Rate
Avg Non-Ag Contract Value	$335,719	0.00060%
Avg Ag Contract Value	$73,725	0.00136%
Avg Contract Value	$285,957	0.00064%

Regardless of the comparison, it is clear that the LST proposal is well within Taiwan FTT tax rate ranges. *The proposed LST effective tax rate is very low.* For comparison, it is *5,000 times lower* than the roughly 3.2% sales tax paid by working class gamblers in Illinois Casinos (see: http://www.cpegonline.org/wp-content/uploads/2015/06/Chicago-Doesnt-Need-Another-Casino_Final_2.pdf) , and *9,766 times lower* that the 6.25% state sales tax that average Illinoisans pay on most consumer goods.

Reportedly (see link above) the multi-tiered Taiwan FTT (see p. 6 of link above):

"…helps to identify the desirable level of reduction in trading activities, which should be large enough to reduce short-term speculative trading, but not so large as to hamper normal functioning of markets."

The $1 or $2 LST is not large enough to completely suppress "short-term speculative" trading but to the extent that it does this, it would be a good thing. It was designed to be a particularly *small* financial transactions tax that would not result in a sufficient reduction in exchange revenues to provide a rational inducement to relocate. If complete data and relocation costs do reveal that it would be rational to relocate, the tax can be readjusted so that HFT traders (the only kind of trading that is likely to be significantly affected by the LST) pay less, for example by lowing the tax for (very) short term positions. However, as is noted above, this would dilute the *desirable* suppression of HFT policy outcome that is reportedly one of the goals of the Taiwan FTT.