SECTION 2 • CHAPTER 7

Ensure capital is available for growth

Specialist Joseph Mastrolia, left, works with traders at his post on the floor of the New York Stock Exchange, May 31, 2013.
AP PHOTO/RICHARD DREW

In a complex global economy, it is more important than ever that our banking and financial system functions efficiently and effectively. America's 300 million engines of growth need strong capital markets to grow businesses and bring their ideas to fruition. Simply put, we all have an interest in strong capital markets.

The U.S. financial sector is the largest in the world, tripling in size relative to national income in the post-World War II period.[1] The 2008 financial crash, however, laid bare weaknesses in the sector that had been building up for years, and the consequences for American workers and their families were severe. The cost of the crisis has been seen in millions of jobs lost and the destruction of $17 trillion in household wealth.[2] The average net worth for American households dropped from $126,400 in 2007 to $77,300 in 2010[3]—wiping out almost two decades of gains and dramatically weakening the middle class.

The biggest financial crash since the Great Depression was followed by the most sweeping reforms since the banking acts of the 1930s. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 pledged to protect American taxpayers and end the era of "too big to fail."[4]

In the wake of the crisis, many economists look at the increased share of the economy that the financial industry comprises as a cause for concern and possibly the product of rent seeking, where market power and the protections and supports of the government have rendered the financial sector more profitable than other sectors.[5] The concern is that the growth of the financial sector has the effect of diverting investment from nonfinancial sectors, which would make better use of that capi-

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tal. The counterargument is that the growth of the financial sector reflects a competitive advantage for the United States in finance, and the industry is a source of jobs and profits that ultimately benefit the economy.

To whatever degree the points above on the financial sector are true, one of the impetuses of Dodd-Frank was to reduce the level of support for the industry from government. Ultimately, the government will always have a role to play as lender of last resort and in resolving failed financial institutions, but Dodd-Frank, in essence, strengthens the regulatory structure so that any government support comes with strings attached, conditions that would effectively lessen the value to the industry of the supports it would get.

In 2012 the Center for American Progress published an assessment of Dodd-Frank, titled "Dodd-Frank Financial Reform After Two Years,"[6] noting what had been accomplished already and the important work outstanding in implementation. At this point it is premature to predict whether the implementation of Dodd-Frank will have its desired effect. But one thing is certain: It is critical that the Dodd-Frank rule writing be finished quickly so that the law can be allowed to work—from addressing proprietary trading and moving derivatives onto open exchanges to effective compensation reform.

With so much important work still to be done to implement Dodd-Frank, the question we wish to address is, what else can be done to encourage productive investment and improve economic growth?

We propose two ideas for policy solutions:

- Implementing a financial transaction tax, which would discourage high-frequency trading and dampen excessive speculation
- Supporting small-business lending, which fuels a critical part of the economy

Policies to curb problematic high-frequency trading

The majority of stock market trades are now made by high-frequency traders.[7] All trades in stock markets and other assets are by nature speculative. Whereas some buying and selling represents the investment decisions of those betting on real growth prospects or people needing financial services to hedge risks, significant trading activity is increasingly turning toward computerized high-volume trades with

AT A GLANCE

Capital

Problem: Key reforms passed as a result of the recent financial crisis have yet to be fully implemented, creating direct and indirect risks for American families and future economic growth. Additionally, popular trading strategies conducted without adequate supervision or regulation have the potential to destabilize markets, and difficulty accessing capital serves as a barrier to growth for some small businesses.

Solution: Ensure that the remaining elements of Dodd-Frank are implemented quickly and effectively. Strengthen markets by addressing the problematic aspects of high-frequency trading and supporting small-business lending.

Key policy ideas:

- Institute a small financial transactions tax.
- Support small-business lending via the Community Development Financial Institutions Program, or CDFI Fund, the State Small Business Credit Initiative, the Small Business Lending Fund and the New Markets Tax Credit.

Outcomes: The United States will have stronger, more vibrant capital markets as a result of smartly enforced regulation and support for small business. ■

dubious social value. Such trading based on tiny changes in prices have amplified the market's undulations and put retail investors at significant disadvantage to financial insiders.[8] They have also been associated with flash crashes, where market prices fall dramatically in the midst of a perfect storm of algorithmic trading.

A second problem with some high-frequency trading occurs when some traders use technological and informational advantages to trade directly in front of a large order. To gain these advantages, some traders pay to locate their computers at the trading venues and pay to get information about orders made by other parties that allows them to trade before that information is available to the broader public—a practice known as front running.

In either case, these activities can divert capital from investment in the real economy and can undermine investors' confidence in our markets. Because these traders rely on making tiny margins on high volumes of trade, even a very small transaction tax would rein in the problematic aspects of the market.

More than 20 countries have some form of financial transaction tax, including many advanced economy countries and those with leading international financial centers, such as the United Kingdom, Switzerland, Hong Kong, and Singapore.[9] There are also increasingly strong calls for such a tax to raise more revenues and promote more financial stability.[10]

As 11 countries in the European Union move forward with a financial transaction tax, the United States should move forward with its own plan. We propose a tax applied at a very low rate—a 0.117 percent tax on stocks and stock options trading, a 0.002 percent tax for bonds, and a 0.005 for futures, swaps, and other derivatives trading—which would raise an estimated $50 billion a year in revenues and, critically, would remove a source of instability in the market by eliminating front running that serves no useful economic function.

Policies that support small businesses

Small businesses play a critical role in the U.S. economy. According to the Small Business Administration, or SBA, firms with fewer than 500 employees employ half of all private-sector employees and pay almost half of total U.S. private payroll.[15]

Although weak consumer demand following the Great Recession remains the most pressing issue for small-business growth, for small businesses that do want to invest, lack of access to capital can also serve as a barrier to growth.[16] According to a 2012 report by the Small Business Administration, "small firms have been losing ground in the competition with other uses of capital held by depository lending institutions."[17] This trend has been even more acute for small-business loans of $100,000 or less.[18]

Until small businesses begin investing again in expansion and inventories, a key driver of economic growth will be missing from the U.S. economy. In order to improve small-business

Support for a financial transaction tax

A financial transaction tax has support from leaders in business and in economics.

"The tax costs to traders are basically zero, and the commission costs are half a penny a share or something like that. So we've taken the frictional costs out and that helps explain why we've had this orgy of speculation. No question about that. So I like the idea of a transaction cost."

– John Bogle, founder of Vanguard[11]

"These taxes will rebalance financial markets away from a short-term trading mentality that has contributed to instability in our financial markets. They also have the potential to raise significant revenue."

– Open letter to the G20 from 52 financial-market professionals[12]

"The economic value of all this trading is dubious at best. In fact, there's considerable evidence suggesting that too much trading is going on .... But wouldn't such a tax hurt economic growth? As I said, the evidence suggests not—if anything, it suggests that to the extent that taxing financial transactions reduces the volume of wheeling and dealing, that would be a good thing."

– Nobel Prize-winning economist Paul Krugman[13]

"The tax would fall most heavily on short-term holders of securities, such as high-frequency traders, hedge funds, and bank proprietary trading desks. It would fall least on long-term holders such as pension funds, life-insurance companies, and private equity firms. This would likely trigger a shift away from short-term trading in favour of long-term holding that will reduce misalignments in markets and their subsequent abrupt adjustments or crashes."

– Stephany Griffith-Jones, Financial Markets Program Director at Columbia University, and Avinash Persaud, Chair of Intelligence Capital and member of the U.N. Commission on Financial Reforms[14]

In this Aug. 4, 2012 photo, fashion designer and entrepreneur Lynette Tyner works in her home studio in New York. Tyner can count herself among a growing group of minority and immigrant entrepreneurs who are turning to nonprofit micro-financing.
AP PHOTO/BEBETO MATTHEWS

access to capital, we propose bolstering and reauthorizing a number of Treasury Department and SBA programs aimed at freeing up capital targeted to small and medium enterprises.

To support small-business lending, we encourage the following:

- Extending the eligibility window for the SBA 504 program's low-interest refinancing
- Authorizing an additional $1 billion in funding for the State Small Business Credit Initiative, which supports states' small-business lending programs
- Reauthorizing the Small Business Lending Fund for two years with an additional $4 billion to provide capital to community banks and community development loan funds to spur small-business lending
- Doubling the funding of the Community Development Financial Institutions Fund to provide investment, support, and training to CDFIs that provide financial services to underserved communities
- Making the new markets tax credit permanent, ensuring it works for entrepreneurs and small-business growth ■

Endnotes

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