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Taxing Emerging Stock Markets: A Beneficial Policy? Evidence from the Stockholm Stock Exchange, 1907–1939[1]

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The question of whether financial markets should be taxed or not has been debated extensively. In this study, the gradual rise in public taxation of the Stockholm Stock Exchange during the first half of the 20th century is examined and evaluated. The empirical findings, focusing on trading volume and volatility, show that transaction taxes caused substantial crowding out of trading activity and led to lower asset prices. Hence, some support is given to the proponents of a more cautious policy of financial market taxation, especially in emerging stock markets.

INTRODUCTION

Financial markets in the Western world have been a target for taxation. One of the most common taxes has been the securities transaction tax (STT). Proponents for this tax argue that it reduces excess volatility and speculation and yields important state revenues. Tobin (1984) was among the first to propose the idea that increased transaction costs on financial markets would discourage short-sighted speculators and thereby enhance social welfare. More recently, Summers and Summers (1989) and Stiglitz (1989) have also argued that a transaction tax would be a relatively efficient source of government revenue while curbing excessive speculation. Most empirical work concerning transaction taxes have investigated their effect on mature markets in industrialized economies. The balance of this evidence has supported critics of transaction taxes who emphasize that they increase capital costs to firms, lead to thinner securities markets, and distort investors' portfolio allocations. Umlauf (1993) and Saporta and Kan (1997), for example, reported that transaction taxes tend to depress asset prices

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while having no effect on volatility. The same authors, as well as Lindgren and Westlund (1990) and Sun (1999), also have found that transaction costs reduce trading volume.

This article expands the scope of this literature by examining how a securities transaction tax affected one emerging stock market, the Stockholm Stock Exchange, during the pre-World War II period. At the time of the STT introduction in 1909, more than 80% of Swedish public revenues were derived from customs and excise duties on consumption goods. This structure was soon revised, and in less than 10 years, new taxes on labor and capital income were introduced, producing a political response from these newly taxed groups. To measure the effects of the STT, I estimate a linear regression model of the trading volume as a function of transaction taxes and commission fees, and I test for tax effects on asset prices in terms of level and volatility.

THE STT AND THE SWEDISH STOCK MARKET

The Stockholm Stock Exchange was founded in 1863, well before Sweden was industrialized and when there were only about 100 joint stock companies. Due to the undeveloped stock market, most new industrial corporations preferred debt to equity in their finance structure, relying on the developed commercial banking system. When industrialization finally took off at the end of the century, new needs for equity financing emerged. In 1901, the Stockholm Stock Exchange was thoroughly reorganized, substituting its old auction trading system for a continuous call market in which dealers could negotiate directly with each other. When commercial banks were allowed to become exchange members in 1907, the size and importance of the exchange increased considerably as trading volume grew 12-fold that year.

The growth of the financial market soon attracted the notice of the Swedish parliament with its fiscal interest. Furthermore, it became alarmed by a nationwide banking and financial crisis during 1907 and 1908. The Swedish tax system at that time consisted primarily of customs and stamp duties on alcohol and sugar. Inspired by other European countries, the Swedish legislature during the early 20th century started to levy taxes on capital gains and corporate profits. A securities transaction tax was introduced in 1909, designed after the German Stock Exchange tax. Although the desire to raise revenue was given as the reason behind the tax, the government was also concerned about curbing "speculative behavior" on the stock market.[2] The tax rate was set at 0.1% of the price of a transaction, to be equally shared by buyers and sellers for most types of Swedish and foreign securities. Bonds were taxed at a lower rate. In comparison to the STT rates in other countries, the Swedish stock transaction tax rate was substan-

[2] Government bill 1908:152, p. 15. There was one earlier attempt to impose a tax.