WHY DO WE REGULATE SPECULATION?

By David Hirshleifer

Why, in many countries, is there regulation designed to constrain speculation, such as restrictions on short-selling and derivatives, and taxation of securities transactions? There are potentially valid theoretical arguments against speculation based on the idea that it imposes costs ("externalities") on others. The problem can be exacerbated if speculators are irrationally overaggressive.

But in practice, securities regulation is driven by more than economic theory. Voters and the media are often hostile toward speculation and speculators, owing to naïve popular notions about how markets work. Where do these notions come from? I also will argue that people (including experts) tend to overvalue the net benefits of market regulation. But if so, why? I outline some answers based on arguments developed more fully (Hirshleifer, 2008).

Adam Smith viewed the fear of speculators as a kind of folk superstition, similar to the fear of witches. During the Middle Ages, speculative trading of various sorts in commodities was a crime under English common and statute law. But why fear and loathe speculators, rather than musicians, or radishes? For one thing, when a crop fails, it is more satisfying to blame the merchants who are charging high prices than to blame nature.

Furthermore, people perceive that speculation does not create value—"mere gambling." In any exchange transaction, the interests of the traders are partly in conflict. This can be naively construed as a zero-sum game, especially for speculation. It is easy to see the benefit when a restaurant owner serves a customer pancakes. It is hard to see just whom speculators are serving, and what service they are providing.

The benefits of speculation are indirect. Inventors can increase their rewards by speculating on the effects of their creations, which increases their incentives to innovate. Speculators can shift resources to the places and times they are needed, as when a vendor in a flood-prone area maintains an excess inventory of emergency supplies such as batteries and matches.

Speculative trading also helps security prices impound new information. This is vital for guiding financing and investment activity, but not salient. A swashbuckling story about making a killing on the stock of a new social media firm attracts attention. But the fact that such activities promote innovation and help direct capital to strong businesses over weak ones does not.

So the notion that speculators are parasites is enticing. From there, it is tempting to blame them for correlates of their activities, such as market booms and crashes. In reality, price volatility is generally beneficial. Prices must move to reallocate resources in response to fundamental economic shocks. Most observers, however, dislike price volatility on the basis of a string of mental associations: Volatility implies risk, and risk is bad, so volatility is bad.

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Associative reasoning goes further to blame speculators for volatility. Since speculation is most active, and sometimes highly profitable, during volatile market periods, it is found guilty by association.

Some of the biases and misperceptions mentioned, such as suspicion of volatility, are tempting even to experts. But the more general problem is that sophisticated, influential observers, including academics and regulators, tend to be overconfident of their understanding of how markets work. As a result, they underestimate the creativity of markets in addressing possible externality problems.

This is illustrated by the case of security transaction taxes (STTs). STTs designed to limit speculation (rather than just raise revenues) are prevalent globally, and have been proposed repeatedly in the U.S. Supporters include such luminaries as Keynes, Tobin, Stiglitz and Summers. This is at first surprising, since the casual first presumption of an economist would be that a transactions tax is a creator of negative liquidity—*prima facie* a bad thing. This point is much like Kenneth Boulding's comment that a tariff is like a negative railroad.

However, as mentioned earlier, speculation creates externalities. Does it really follow that government needs to step in to correct them? Or might it be that market institutions can respond to internalize the externalities, reducing speculation when it is excessive? In reality, securities exchanges make choices that determine the liquidity of stocks, such as deciding whether to designate a market maker with an obligation to maintain liquidity.[1] In recent years, international exchanges have had greater negotiation with individual listed firms about means of creating liquidity for their stocks. Firms have a variety of means of making their shares illiquid, such as not going public, or by going private. They thereby create their own "transactions taxes." Simply by refraining from stock splits, Warren Buffett's Berkshire Hathaway has maintained a high stock price that reduces liquidity and limits trading. Firms that choose to offer less information disclosure reduce liquidity by creating information problems for investors. Mutual funds use front- and back-end loads to limit inflows and outflows; closed-end funds take flow decisions out of investor hands.

So even a fairly perfunctory examination turns up a plethora of means by which firms, financial intermediaries and exchanges regulate liquidity, and at least to some extent internalize the effects of speculation. These mechanisms certainly do not eliminate all externalities. But to evaluate the desirability of transactions taxes on a practical level, one must weigh costs and benefits. To measure the net benefits of securities transactions taxes requires assessing the extent to which markets, when left alone, internalize some of the externalities. Proponents of securities transactions taxes have not, to my knowledge, provided such an assessment.

It is odd that most of us abhor the idea of suppressing deviant speech by taxing the press or shutting universities, yet don't mind government suppression of the opinions of speculators. I'd argue that more harm is done by people who express pernicious opinions than people who make pernicious stock trades. The greater willingness to tolerate intellectual than financial speculation seems to be a result of mere prejudice. ■

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References

1 A possible rationale for obliging market makers to maintain liquidity for a stock is to internalize externalities between market makers and other traders. Market makers may sometimes prefer not to trade, as opposed to losing money to investors with superior information. But such losses are mere redistributions of wealth, not social costs (Bessembinder, Hao, and Lemmon 2007).

Bessembinder, H., Hao, J., and Lemmon, M., 2011, "Why Designate Market Makers? Affirmative Obligations and Market Quality," University of Utah.

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