

Transaction tax and market quality of the Taiwan stock index futures

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Abstract

On May 1, 2000, the Taiwan government reduced the tax levied on futures transactions on the Taiwan Futures Exchange from 5 to 2.5 basis points. This event provides a unique opportunity to test empirically the impact of a tax rate reduction on trading volume, bid-ask spreads, and price volatility. Intraday and daily time series data from May 1, 1999, through April 30, 2001, are tested in a three-equation structural model. Findings show that transaction taxes have a negative impact on trading volume and bid-ask spreads, as trading volume increased and bid-ask spreads decreased in the period following the reduction in the transaction tax. This study's analysis is not consistent with the argument that the imposition of a transaction tax may reduce price volatility because there are no significant changes in price volatility after the tax reduction. Further, it was found that although the reduction in the transaction tax did reduce tax revenues, the proportional decrease in tax revenues is less than the 50% reduction in the tax rate. Finally, tax revenues in the second and third year after the tax reduction increased, as compared to the year before the tax reduction. © 2006 Wiley Periodicals, Inc. *Jrl Fut Mark* 26:1195–1216, 2006

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