Parallax and Tax

Abstract: Common valuations pose an obstacle to trade and, hence, an existential threat to brokers, who profit from taxing trade. We write down a model in which a broker drives a wedge between valuations by deceiving gullible traders. Separate valuations facilitate arbitrage, and arbitrage generates brokerage fees. We then show that this process, which we call parallax and tax, explains a classic case of market inefficiency: the favorite-longshot bias in horserace parimutuel markets.