ANALYSIS OF PROPOSED COMMODITY TRANSACTION TAX ON DERIVATIVE TRADING IN INDIA

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Abstract

There has been considerable debate on the proposed commodity transaction tax (CTT) in the commodity derivative market. While the CTT was proposed to generate revenues and discourage speculative trading, however the benefits are likely to be outweighed by its potential costs because it would increase the cost of capital and reduce market liquidity. Empirical evidence suggests that when a government levies or increases transaction tax on domestic markets, investors shift their trading to overseas markets. This study makes an attempt to assess the impact of proposed transaction tax on liquidity, volatility, prices and efficiency of commodity derivative markets in India.

Key Words: Commodity Transaction Tax, Liquidity, Security Transaction Tax, Volatility

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I. Introduction

Commodity Transaction Tax (CTT) for commodity derivative trading in India which will impose on commodity derivative transaction. This tax stipulates that sale of a commodity in commodity derivative market would attract 0.017 percent of CTT calculated on the basis of selling price, which is payable by the seller. The Government of India had proposed to impose CTT in budget 2008-09, but could not be implemented amid protests from exchanges and in recognition of the fact it could potentially undermine the futures segment that helps in price discovery for the benefit of all producers including farmers. Again on 2012-13 budget the Finance Ministry`s proposed move to impose CTT on the rationale that imposition of CTT would help to contain volatility in future markets while bringing in more transparency in its operation.

II. Commodity Transaction Tax in India

The government of India has proposed to impose CTT at the rate of 0.017 percent of the value of transaction in budget 2012-13 in line with the Securities Transaction Tax (STT) thereby bringing the futures market under the net of service tax.

As per Agricultural Produce Marketing Committee Act (Department of Banking Operations and Development, 2005) no mandi fees, sales tax/VAT, excise, customs and octroi is payable by the farmers. But, the CTT shall be charged in respect of every taxable commodities transaction. It implies that a farmer, who sells a futures contract to protect himself against price risk, will be required to pay CTT. This implies that the tax benefits provided to the farmers is not extended to their transaction in the commodity derivative market.

A World Bank report (1996) has found that Indian Commodity derivatives market (CDM) is a market with a single product (i.e. - only futures and no option, index futures, or intangible futures) and a single user (i.e. only traders and corporate and no banks, mutual funds or FII), while capital market has a multi-product (cash, futures, options, indices, debt, interest rate) and multi-user (FII, mutual funds, banks, traders) platform.

Table-1: Comparison of NSE and Commodity exchanges trading turnover

Financial	Daily average turnover for the year (Rs. Cr)

Year	NSE Futures	NSE Options	Commodity Futures**
2006-07	25674.42	3971.81	11907.19
2007-08	45295.89	6857.56	12889.76
2008-09	29011.30	16299.30	16942.08
2009-10	37416.56	34975.53	25718.44
2010-11	38788.75	76361.06	38753.38
2011-12*	29891.81	94401.81	58893.38

Source: Jha, 2012

*Till 31 January, 2012

**Aggregate of all commodity exchanges complied by BS Research Bureau

A Securities Transaction Tax (STT) was imposed on the capital markets in 2004, in the derivatives and cash delivery segment, and raised in both 2005 and 2006. The levy and subsequent increase resulted in a big shift of business from futures to the alternative instrument of options on the National Stock Exchange (NSE). Data compiled by the Business Standard Research Bureau in Table-1 show overall daily average trading during 2006-07 was Rs 3,971 crore in the options segment on the NSE; it had jumped to Rs 79,361 crore in 2010-11 and has reached Rs 94,401 crore so far in the current financial year. Since options are not available on the commodity derivative platform, a large chunk of business would shift to exchanges abroad (Jha, 2012).

There is a basic difference between the two markets; while the capital market promotes capital formation and appreciation, the commodity derivative market operates to provide insurance against price volatility and to facilitate price discovery. However an insurance product is attractive, only if it is reasonably priced. Hence if derivative contracts becomes very expensive they automatically become unviable where people prefer to remain uninsured rather the pay such a high premium for their protection. In this context unlike STT, CTT presents the danger of making commodity derivative too expensive and hence unviable. .

There is an ongoing effort to widen the participation on local commodity exchanges by permitting access to foreign participants, local banks and Mutual Funds. However, the interest from global players will be limited if the cost of transaction on domestic exchanges is significantly higher than international ones. The Sahoo and Kumar (2008) in Table-2 points out that the CTT entails a rise of total transaction cost from Rs. 2.00 per lakh to Rs. 19.25 per lakh,

which is more than 950 percent increase on an average. This, it is feared, would act as a deterrent to foreign participation, if imposed. Moreover other Indian players like mutual funds, insurance, banks etc would also shy away from the commodity derivative market defeating the basic objective of market widening.

Table-2: Impact of Commodity Transaction Tax (CTT) on Transaction Cost

Cost Components	Transaction cost before CTT	Transaction cost after CTT
Exchange Transaction Fees	Rs.2 to 3 per Rs.100000	Rs.2 per Rs.100000
Service Tax	Nil	Rs.0.25 per Rs.100000
CTT	Nil	Rs.17 per Rs.100000
Total Cost	**Rs.2 per Rs. 100000**	**Minimum of Rs.19.25 per Rs.100000**

Source: Sahoo and Kumar, 2008

Transaction cost in commodity derivatives in India will become very high as compared to international market like New York Metal Exchange (NYMEX), Chicago Board of Trade (CBOT), Tokyo Commodity Exchange (TOCOM), Shanghai Future Exchange (SFE), Singapore International Monetary Exchange (SIMEX), Chicago Mercantile Exchange (CME), Osaka Securities Exchange (OSE) (Japan), if the proposed CTT is actually implemented. In fact, as the Table-3 indicates such an enormous differential projected evokes the apprehension that existing players might shift to foreign markets if such a situation arise.

Table-3: Projected Transaction Cost (with imposition of CTT): A Global Comparison

(Cost Comparison of a sale of Rs.100000)

Exchanges	Exchange Fee	Service Tax	Regulatory Fee	Stamp Duty	CTT	Others Charge	Total Cost
MCX	2.00	0.25	Nil	1.00	17.0	Nil	20.25
NYMEX	0.74	Nil	0.07	Nil	Nil	Nil	0.81
CBOT	2.93	Nil	0.25	Nil	Nil	Nil	3.18
ICE	0.82	Nil	Nil	Nil	Nil	Nil	0.82
TOCOM	1.23	Nil	Nil	Nil	Nil	0.06	1.29
CZCE	4.76	Nil	Nil	Nil	Nil	Nil	4.76

NYBOT	2.41	Nil	0.40	Nil	Nil	Nil	2.82
CME	2.66	Nil	0.18	Nil	Nil	Nil	2.84
DCE	3.64	Nil	Nil	Nil	Nil	Nil	3.64
MDEX	2.89	Nil	Nil	Nil	Nil	Nil	2.89
WINNEPEG	5.62	Nil	Nil	Nil	Nil	Nil	5.62

Source: Schulmeister, Schratzenstaller, and Picek (2007)

Note: The above transaction cost apply only to Electronic transactions and fee structure collected from various exchanges websites as a quick reference guide for general information purposes. Transaction fees may be changed at any time without notice.

The rationale for levying CTT may have been guided by the following argument.

(i) Generating revenue: one of the motives for levying CTT is to generate tax revenues. However actual realization of revenue from CTT may not be significant if the volume of trading falls in response to the CTT. In fact, Umlauf (1993) asserts that traders may shift their investment to foreign exchanges in order to seek lower transaction tax and retain profit.

(ii) Tracking information for better tax compliance under CTT may have been designed as an anti-evasion measure. But all national commodity exchanges have world class surveillance systems with proper auditing and are regulated by FMC. Sahu (2008) has indicated that tracking is always possible even without imposition of CTT, and as such this cannot be used as a rationale to justify the imposition of CTT.

(iii) Promoters of CTT believe that such a tax could serve as anti-volatility and anti-inflationary instrument by reducing excessive trading. However Nath and Lingareddy (2008) revealed that increase in transaction tax may not necessarily check price volatility. The volatility and the inflationary pressures stems from a number of factors, including supply side constraint, the global rise in prices of food and oil, the diversion of land for bio-fuel production, loose monetary policy in emerging economies, and the adoption of an expansionary fiscal policy. Hence the proposed policy of across-the-board impose CTT on commodity derivative trading appears to be unjustifiable, inequitable, and

counter-productive. If any anti-inflationary strategy pertaining to the commodity derivative market is to be relevant and efficient then it must be substantive evidence of its inflationary character is gathered and tested for authentication.

III. Impact of Transaction Tax- Global experience

There has been considerable debate on the pros and cons of transaction taxes in the commodity derivative market. The proponents of the tax argue that CTT would generate revenues and discourage speculative trading. While the opponents argue that the benefits of a transaction tax are likely to be outweighed by its potential costs because it would increase the cost of capital and reduce market liquidity (Amihud and Mendelson, 1993).

Empirical evidence suggests that when a government levies or increases transaction tax on local markets, investors shift their trading to overseas markets. For example, in 1987, Japan started imposing a transaction tax on securities and commodity futures ranging between 0.3 percent and 1 percent of the transaction's full value. Initially, the tax generated 4.2 percent of Japan's general account revenue in 1988, but by 1993 the revenue share had fallen by 96 percent because of the shift in market volume to less-taxed, offshore locations (Maxim, Dec-2004). Following that, Japan did away with this tax recognizing that it had diminished its market's liquidity without raising revenue.

A similar story unfolded in Taiwan which had imposed a transaction tax of 0.05 percent on the value of the commodity futures contract in 1993. This affected the Taiwan Futures Exchange (TAIFEX), which lost trading volume to the Singapore Exchange (SGX). In 2000, Taiwan reduced the transaction tax to .025 percent, and in 2005 furthered reduced it to 0.01 percent. TAIFEX's volume then jumped from 31.87 million contracts in 2003, to 92.66 million contracts in 2005. The competitive advantage enjoyed by the SGX diminished and trading shifted back to Taiwan. In fact, although Taiwan's revenue generated by the transaction tax declined immediately after the tax reductions, but three years later, the increase in volume had caused revenue to exceed previous levels (Chou, Robert and Wang G; May 2006). In the case of Sweden, Umlauf (1993) reports that when the STT was increased to 2 per cent in 1986, 60 per cent of the trading volume of the 11 most actively traded Swedish share classes migrated to

London, where there was no transaction tax. This was equal to 30 per cent of the total trading volume. By 1990, the volume had increased to 50 per cent.

Following global experiences, many countries have reduced or completely eliminated their commodity futures transaction taxes and securities transaction taxes. A University of Massachusetts's study found that of 38 countries with transaction taxes on securities and futures, 17 have reversed their policy and reduced or removed the taxes (Baker, Pollin and Schberg; 2001). In the context of the above discussion, imposition of CTT by 0.017 percent would substantially increase India's transaction cost which may become the highest in the world. The prime beneficiaries of India's proposed transaction tax on commodity futures trading will likely be India's economic competitors China, Taiwan, Malaysia, and Singapore all which have growing commodity futures markets. If the Indian transaction tax is passed these foreign markets will appropriate the jobs, wealth, and foreign investment that would have otherwise been India's. Unless India learns from history it may lose to China or Singapore what Germany lost to England?

IV. Conclusion:

The Government of India's proposed commodity transaction tax on futures trading at the rate of 0.017 percent of the value of transaction second time in budget 2012-13 to generate government revenues, achieve neutrality in government taxation policy between the commodity derivative market and capital market, and to contain price rise and market volatility. The benefits of CTT are likely to be outweighed by its potential costs because it would make the Indian commodity derivative exchanges uncompetitive with a transaction cost which is way above the international exchanges. This would drive away investors to the international exchanges or make them go underground into illegal trading (dabba trading) where traders settle their transaction on exchange prices without paying any margins or taxes.

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