Equitable Equity

India Introduces Securities Transaction Tax

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On July 8, 2004, India's Finance Minister, P. Chidambaram, presented Finance Bill (Bill No. 22, 2004) in Parliament in which he proposed the introduction of Securities Transaction Tax (STT) in the Indian financial markets. Under the proposal, every transaction in securities in a recognized stock exchange in India would attract a turnover tax of 0.15 per cent. Transactions in stock and index options and futures would also be subject to transaction tax. Whereas transactions carried out on the Negotiated Dealing System (a screen-based system for trading in government securities and bonds) operated by the central bank, Reserve Bank of India, have been kept out of the purview of this tax. Only the buyers of securities would pay the proposed tax. After collecting this tax from the buyer, the broker would pay it to the stock exchange, which would then pay it to the exchequer. The proposed STT would come into effect only after the Finance Bill is passed by Parliament. After acquiring the assent from President, the government would issue a notification to make the tax operational. This entire process may be completed in the next three months (September 2004).

The mandarins in the Finance Ministry have supported the introduction of the STT in order to simplify the tax regime on financial market transactions. The authorities believe that the STT is a clean and efficient way of collecting taxes from financial markets. That is why, the introduction of STT has been linked with the dismantling of existing tax structure on capital gains. While introducing the STT, the Finance Minister proposed to abolish the tax on long-term capital gains altogether and reduced the short-term capital gains tax from 33 per cent to 10 per cent.

There is no denying that STT could act as an efficient instrument to collect the taxes, as many market players fudge transactions to evade capital gains taxes but it would be erroneous to consider STT (indirect tax) as a substitute to capital gains tax (direct tax). If there are problems in collecting capital gains taxes, these should be sorted out rather than reducing and abolishing it altogether. Further, to justify the introduction of STT only in terms of smooth collection of taxes would be a serious mistake. There are several other benefits of STT in the Indian financial markets.[1]

The Rationale

There are several justifications for the adoption of STT in the Indian financial markets.

First, the underlying logic of securities transaction tax is to slow down the flow of speculative money, as it would be taxed each time a transaction takes place. The STT is expected to curb purely short-term speculation by day traders, "noise traders," arbitrageurs and big operators without significantly affecting the long-term investors. The tax on equities held for a long period would be marginal while the tax on short-term trading would be higher.

[1] While proposing a securities transaction tax of 0.25 per cent in the Indian equities markets, the author had discussed other benefits besides revenue collection. For details, see, Kavaljit Singh, *Tax Financial Speculation: The Case for a Securities Transaction Tax in India*, ASED-PIRC Briefing Paper, 2001 (also available online at www.ased.org).

The STT would be a significant deterrent to speculators and day traders trying to make a quick profit on a huge sum by just trading, without taking any deliveries of stocks. The proposed tax would keep such players away, as they would have to factor in the tax cost.

The STT is expected to reduce the speculation in Indian financial markets, which are amongst the most speculative markets in the world. Compared with several leading international financial markets, the sheer volume of speculative trading in Indian markets is extremely high. It has been pointed out that Indian financial markets are second only to NASDAQ in speculation, thereby surpassing some of the leading international financial markets such as the New York Stock Exchange (NYSE), London Stock Exchange, and markets in Hong Kong, Singapore and Japan.[2] Despite a sharp increase in the daily turnover in the Indian financial markets, actual deliveries are less than 20 per cent of trading. Due to excessive speculation, much of trading in the Indian markets is concentrated in a handful of stocks. The top 10 stocks account for over 80 per cent of the turnover of the Indian financial markets. The top 100 stocks account for almost 99 per cent of the turnover. While there are several thousand stocks listed in the markets that are not traded at all.

The speculative nature of Indian financial markets can also be gauged from the fact that the volume of secondary market trading has increased several times while new capital raised through primary market has significantly declined over the years. As rightly pointed out by L C Gupta, former member of SEBI, the high volume of speculative trading has not helped even a bit in strengthening the market’s capital raising function, rather it had the opposite effect.[3]

Over the years, we have witnessed that excessive speculative trading by big players more often than not degenerates into market manipulation. There is an entire history of frauds in the financial markets starting from the securities scam of 1992. The financial frauds recurring at regular intervals reveal that our financial markets are prone to abuse, manipulation and excessive speculation.

India has also the distinction of having extreme price volatility at the individual stock level. Short-term trading is one of the major factors responsible for increased market volatility. The financial literature suggests that transaction taxes increase asset price efficiency by curbing excessive volatility. By raising the cost of speculative trading, STT would contribute towards restraining short-term trading, thereby making Indian financial markets less volatile and more efficient. In the present times, the stability in financial markets is of utmost importance because the Indian policy makers are determined to invest pension funds in the financial markets. As any negative development in the financial markets can adversely affect savings, investments, exchange rates and interest rates, it is high time that financial stability should also be treated as a public good.

Second, the revenue potential of a 0.15 per cent of STT provides another justification. On an average, the daily trading in the Indian stock markets is about Rs 100000 million. By imposing a 0.15 per cent STT on this volume, the Indian tax authorities can collect Rs 150

[2] See, for instance, B. G. Shirsat, “Indian Bourses Second-most Speculative after Nasdaq,” *Business Standard,* April 5, 2001; and Rishi Chopra, “Excessive Speculation Plagues Capital Markets,” *The Economic Times,* May 8, 2001.

[3] L. C. Gupta, “Regulatory Confusion,” *The Economic Times,* November 1, 2000.

million every day. As Indian financial markets operate on an average 250 days a year, STT could generate revenue of Rs 37500 million every year. This is a substantial amount in the present times when country is finding it difficult to raise revenues through taxation. India's tax-GDP ratio is among the lowest in the world and has fallen particularly in the 1990s – the decade of economic liberalization and globalization.

Further, the need of the hour is to tax the financial economy that has remained undertaxed despite tremendous growth in the recent years. To a large extent, this has happened due to several loopholes in the present tax system, which have been consistently exploited by the big operators in the financial markets. For instance, the foreign institutional investors (FIIs) avoid paying taxes in India by routing their investments through Mauritius, which has signed double tax avoidance treaty with India. Under this treaty, corporate bodies registered in Mauritius would be taxed under the Mauritian law rather than Indian law. Since Mauritius does not tax capital gains and dividend, it is no surprise that bulk of portfolio investment as well as foreign direct investment into India is routed through Mauritius. But once the STT is implemented in India, evasion of taxes by the FIIs and other international fund managers through such tax treaties would be effectively curbed.

The revenue raised through STT could be utilized in several ways. Given the fact that Indian authorities are too much worried over the current fiscal situation, they can use this tax revenue to reduce the fiscal deficit. Alternatively, a part of these financial resources can be deployed to support specific developmental and anti-poverty programs in the country.

Third, an additional advantage of STT is that it could discourage "hot money" flows, which are known for their volatile and destabilizing behavior. As recent international experience shows that developing countries are more vulnerable to "hot money" flows, STT could ensure some degree of insulation to the Indian financial markets from the deleterious effects of such volatile financial flows.

Fourth, by cutting back financial resources in unproductive speculation, STT could encourage long-term financial flows. The speculative activity in the financial markets diverts large amounts of resources away from productive purposes. As a result, fewer financial resources are available to fund long-term economic development. In the long run, STT has the potential to benefit the real economy.

Fifth, another main benefit of the STT lies in its progressive outlook. As the major players in the financial markets are big speculators, day traders, arbitrageurs, brokers and wealthy individuals, whose numbers in any case are miniscule, STT would only affect their businesses without directly affecting the majority of Indians. As the victims of volatile financial markets are often small investors, the proposed tax would help in providing some protection to the community of small investors.

The wider economic and developmental gains of taxing speculative money are more than the private gains of a handful of speculators, financiers and traders. If gambling in a casino or a state lottery ticket is considered an immoral act and therefore heavily taxed, there is nothing wrong with a modest tax on speculation. Gambling in the financial markets is no qualitatively different from gambling in a casino.

Sixth, the securities tax is much easier to implement. It is a clean and efficient instrument of collecting taxes from financial markets as collections will be centralized through the stock exchanges. Further, unlike Tobin tax[4], STT does not require any international consensus or agreement to levy it. India, like any other country, is free to levy STT.

International Experience

Not long ago, taxes on financial transactions have been imposed in several countries including the US, Japan, France and the UK. Several countries are still implementing different types of financial transaction taxes. Table 1 provides the list of countries that have imposed transactions taxes of various kinds. Some countries have imposed tax on stock trading while many others have taxed a variety of financial transactions.

The US imposed a financial transaction tax from 1914 to 1966. During this period, the US had a federal tax on stock sales of 0.1 per cent at issuance and 0.04 per cent on transfers. Currently, the US has a 0.0034 per cent tax which is levied on stock transactions. The tax, known as Section 31 fee, is used to support the operation costs of the Securities and Exchange Commission (SEC). In 1998, the federal government collected $1.8 billion in revenue from these fees in 1998, almost five times the annual operating costs of the SEC.

The UK has a financial transaction tax in the form of a stamp duty, which is not levied on transactions *per se* but on the registration of securities. The stamp duty has been in effect for many decades, and in recent years, it has been reduced. Presently, UK levies a 0.5 per cent stamp duty and stamp duty reserve tax on equity and other financial transactions. No one can claim legal ownership of stock without the stamp. Transactions in UK registered shares carried outside the country are liable to stamp duty only when the document enters the UK. While there are no territorial restrictions on the stamp duty reserve tax. The buyers pay the stamp duty and stamp duty reserve tax. During 1998-99, the authorities collected 2.1 billion pounds from securities transactions.

Belgium is another European country which has a 0.17 per cent transaction tax on stocks and a 0.07 per cent tax on bonds. Transactions in other financial instruments are also taxed, under varying rates. Both buyers and sellers are subject to the tax, but the tax base is calculated differently. Further, there is a ceiling of 10000 Belgian francs on the joint amount payable. However, certain financial intermediaries are exempted from the tax.

Till 1999, Japan had also imposed a transaction tax. The tax was imposed on a variety of financial instruments. The tax was levied on both debt instruments and equity instruments but at differential rates. For instance, the tax rates were higher on equities than on debentures and bonds. Implementation of a FTT in Japan was quite successful as the government raised substantial revenue from it. In the late 1980s, the Japanese government was generating revenues of about US $12 billion per year. This is not an insignificant amount. However, as part of "big bang" liberalization of the financial sector, Japan withdrew this tax in 1999.

[4] Professor James Tobin in his Janeway Lectures at Princeton first proposed a tax on global foreign exchange transactions in 1972, it came to be popularly known as Tobin tax. Realizing the need for "throw(ing) some sand in the wheels" of global financial markets, Tobin advocated the tax as a mechanism for discouraging speculation in short-term foreign exchange dealings. He proposed a 0.25 per cent tax on currency transactions in order to control volatility in the international currency markets and to preserve some autonomy in national monetary policies.

Table 1: Transaction Taxes around the World

Country	Tax Size	Description	Changes since 1991
Australia	0.3%	Transaction tax	Additional stamp tax removed in 1991
Austria	0.15% 0.06% 0.04%-0.09%	Transfer tax Arrangement fee Courtage fee	May be avoided by trading off exchange May be avoided by trading off exchange
Belgium	0.17% 0.025%	Stamp tax on purchases and sales Stock market fee	No tax ex country; maximum of 10,000 Belgian francs No tax ex country; maximum of 2,500 Belgian francs
Finland	0.5%	Transaction fee	Waived if parties foreign; eliminated in 1992
France	0.15%	Trading tax	Tax on trades greater than 1 million francs; rate is doubled on smaller transactions; may be avoided by trading ex country
Germany	0.125% 0.06%	Boersenumsatzsteuer Courtage tax (official border fee)	Residents only May be avoided by trading ex country
Hong Kong	0.25% 0.006% 0.05%	Stamp duty Special levy Exchange levy	 May be avoided by trading off market May be avoided by trading off market
Italy	0.05%	Stamp duty tax	May be avoided by trading ex country
Japan	0.30%	Sales tax	May be avoided by trading ex country; eliminated in 1999
Malaysia	0.05% 0.3%	Clearing fee Transfer stamp duty on purchases and sales	Maximum $100; may by avoided by trading off exchange Eliminated in 1992
New Zealand	0.0057% plus per trade fee	Transaction levy	May be avoided by trading off exchange; eliminated in 1992
Singapore	0.1% 0.05% 0.2%	Contract stamp duty Clearing fee Transfer stamp duty	May be avoided by trading off exchange Maximum $100; may be avoided by trading off exchnage Purchase only; eliminated in 1992
Sweden	0.5%	Turnover tax	May be avoided by trading ex country; eliminated in 1991
Switzerland	0.0005% 0.01% 0.075%	Exchange fee State tax Stamp tax	May be avoided by trading ex country May be avoided by trading ex country May be avoided by trading ex country
United States	0.0034%	SEC fee	
United Kingdom	2 pounds 0.5%	Levy Stamp duty tax	On trades over 5,000 pounds On purchases only

Source: Compiled by author from various sources including Jeffrey Frankel, "How Well Do Foreign Exchange Markets Work: Might a Tobin Tax Help?," in Mahbub ul Haq, Inge Kaul and Isabelle Grunberg (eds.), *The Tobin Tax: Coping with Financial Volatility*, Oxford University Press, New York, p. 70, 1996; and Karl Habermeier and Andrei Kirilenko, "Securities Transaction Taxes and Financial Markets," *IMF Working Paper*, WP/01/51, IMF, May 2001.

Italy has a transaction tax in the form of stamp duty. The country levies a 0.14 per cent stamp duty on domestic off-exchange transactions. Likewise, Switzerland also has a stamp duty on financial transactions. Switzerland levies a 0.15 per cent tax for transactions in Swiss securities and 0.3 per cent for transactions in foreign securities. Besides stamp duty, the country also levies a share turnover fee of 0.0001 per cent. In recent months, the Swiss authorities have exempted several financial intermediaries from the fee.

Sweden and Finland introduced a transaction tax on a host of financial instruments in the mid-1980s. However, the existing financial literature suggests that the introduction of tax was a complete failure in Sweden and Finland. In the case of Sweden, not only the revenues dropped but the FTT also contributed towards migration of stock trading from Stockholm to other financial centers.

France has a transaction tax on equity trading. The tax rate depends on the amount of transactions. The country levies has a 0.15 per cent transaction tax on equity trades exceeding 1 million francs. For transactions below 1 million francs the rate is higher, at 0.3 per cent. There is a ceiling of 5000 francs on the total tax amount. The tax is payable by both sellers and buyers. Certain shares and financial intermediaries are exempted from this tax.

Among the emerging markets, Malaysia, Singapore, New Zealand and Hong Kong have imposed transaction taxes on a variety of financial instruments. Thus, there is a vast international experience (both positive and negative) with transaction taxes.

The Market Response

Since the introduction of STT has been linked with the dismantling of existing capital gains taxes, small investors and long-term institutional investors have welcomed it. But a powerful lobby of brokers, day traders, arbitrageurs, and “noise traders” launched an impromptu agitation against the proposed tax. Some traders even called it the “Terminator Tax.” The implementation of STT is strongly resisted by fly-by-night operators and “noise” traders, as their speculative profits would be adversely affected and they are likely to be driven out of the market. However, one fails to understand the opposition of brokers to the STT since it is the buyer of stocks (not broker) who would be paying this tax.

The apprehension of the opponents that STT would drive out large financial transactions from Indian financial markets may not prove true because the cost of a 0.15 per cent tax on long-term investments would be almost negligible. A modest increase in the cost of financial transactions due to STT would not lead genuine investors (both foreign and domestic) to flee markets. Another notion that the proposed tax would dry up liquidity in the markets also lacks conviction. No doubt that trading volumes generated by intra-day speculators would be affected, but a small tax of 0.15 per cent cannot bring Indian financial markets to a standstill. Similar apprehensions were expressed when other policy measures (e.g., banning of *Badla* system and implementation of rolling settlement) were introduced in the Indian financial markets in 2001. But experience shows that such measures had no impact on the liquidity. Moreover, the sheer dependence on day traders and speculators to provide liquidity reflects inherent weaknesses of Indian financial markets.

Given the strong opposition to the proposed tax orchestrated by a powerful lobby of brokers and day traders, Finance Minister has agreed to revisit transaction tax. He has given signals that the government could consider several alternatives including a lowering of transaction tax rate and differential tax rates for different securities. While addressing the captains of Indian industry, Finance Minister said, "If anyone can provide me with a better set of numbers than the proposed 0 per cent, 10 per cent and 0.15 per cent tax on long-term capital gains, short-term capital gains and securities transactions, respectively, I will consider that."[5] There is a proposal of exempting day traders and arbitrageurs from the preview of STT. It is likely that under pressure from powerful interests, the government may dilute certain provisions of the proposed tax.

Concluding Remarks

While favoring the implementation of STT, I am not arguing that all problems related to speculation and volatility in the Indian financial markets would be resolved by it. In the present times, no single instrument by itself can solve all problems plaguing the Indian financial markets. However, if used in conjunction with other policy mechanisms (e.g., banning short selling and insider trading), STT does offer a potent mechanism to deal with the multiple problems. Therefore, any attempt to dilute the provisions of the proposed tax should be strongly opposed by all those who are concerned about stability in the Indian financial markets.

[5] Quoted in "Transaction tax may be cut," *Business Standard*, July 13, 2004.