



Financial Markets International, Inc.

818 Connecticut Avenue, NW Suite 300 Washington, DC 20006 Tel: (202) 721 0194 Fax: (202) 721 0198 cseeger@fmi-inc.net

INDIA'S COMMODITY TRANSACTION TAX: ECONOMIC CONSEQUENCES AND INTERNATIONAL LESSONS LEARNED

CHARLES M. SEEGER

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Abstract

This paper assesses the recently proposed Indian Commodity Transaction Tax (CTT) and the foreseeable impact of this tax on the Indian economy. Prudential government regulation, particularly since 2003, has helped India to develop one of the most vibrant commodity sectors in the world. The sector employs millions, generates revenue, and propels growth. A wide range of economic actors in India rely on commodity exchanges for price discovery and to hedge exogenous risk. The proposed CTT fails to understand these economic objectives, and in doing so, is likely to deter commodity trading on Indian exchanges and shift transactions to lower cost exchanges overseas, or to illegal markets. As trade volume decreases, so too will any revenues generated by the CTT. The CTT is further flawed as it disproportionately harms small and medium enterprises, would cause substantial job losses, and unfairly discriminates against certain economic sectors. This paper also provides empirical evidence of the harm of similar transaction taxes in other nations, which have reduced market liquidity and have failed to generate significant long-term revenue.

Financial Markets International, Inc. (FMI) is an international law and economics consulting firm based in Washington, DC. FMI specializes in helping emerging market countries achieve economic growth and development through a reliance on market mechanisms, international best practices, and commercial law reform. Founded in 1992, FMI has worked around the globe for international donor agencies and private sector clients. FMI is well-known for its work in developing securities markets, commodity futures markets, capital markets, and non-bank financial institutions. The firm's work encompasses capital markets development, pension reform, banking, SME access to finance, legislative drafting, institutional development, strategic planning, management information systems, and education and training initiatives.

Charles M. Seeger, J.D., is the President and CEO of FMI. He has provided legal, operational, and prudential advice on commodity risk management to governments, banks, and corporations worldwide. Mr. Seeger is a senior attorney specializing in capital markets development. He is the author of the USAID/New Delhi Roadmap: Commodity Futures Markets Development in India, 2005 and Forward.

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Financial Markets International, Inc.
818 Connecticut Avenue, NW Suite 300
Washington, DC
(202) 721-0194
fmi-hq@fmi-inc.net
www.fmi-inc.net

Introduction

For over sixty years, the Government of India has pursued a measured and prudential path of commodity derivatives regulation.¹ Laws and regulations adopted as part of India's economic liberalization in the 1990s and 2000s created a coherent and reliable legal regime, and sparked a dramatic modernization of India's commodity futures markets. As a result, the total value of commodities traded on India's exchanges exceeded 181 trillion rupees (\$3.5 trillion) in the 2011-12 fiscal year, and this sector accounts for over 1.5 million jobs.

Yet, the Commodity Transaction Tax (CTT) proposed in the Ministry of Finance's 2013-2014 budget threatens to undermine this progress and cripple Indian commodity trading. The proposed CTT reflects a misunderstanding of the Indian commodity market and its important hedging and price discovery functions. It unfairly seeks to discriminate against certain economic actors and sectors, and would significantly harm individuals and small and medium enterprises (SMEs). Moreover, the tax ignores economic theory and the empirical experience of other failed transaction taxes imposed around the world. Further, the CTT is unlikely to generate significant tax revenues because the increased costs imposed by the tax will divert commodity trading away from India to overseas markets. In sum, the CTT is a misconceived initiative with the potential to irreparably harm India's commodity futures markets.

This memorandum outlines that harm, and the foreseeable problems of the new CTT. It provides a brief overview of India's commodity sector and its importance to the national economy; evaluates the proposed tax and details its adverse consequences for the commodity sector; and offers relevant context by recounting the experience of other nations that have implemented similar transaction taxes.

Overview of the Indian Commodity Sector

India's venerable open markets tradition can be traced to the 4th century BCE, when the esteemed scholar and statesmen Viṣṇugupta, or Chanakya, wrote the *Arthashastra*. Writing more than two thousand years before Adam Smith, Viṣṇugupta outlined many of the fundamental tenants of what would later be known as "classical economics." He detailed the importance of commodity trade, market-based prices, mutually beneficial comparative advantage, and a fair tax system that generates revenue and promotes growth, without destroying economic incentives.²

¹ See The Forwards Contracts (Regulation) Act of 1952, and subsequent revisions.

² Kautilya, *Arthashastra*, Translated by R. Shamasastri, Bangalore: Government Press, 1915.

The legacy of the *Arthashastra* was apparent in the late 19th century, when merchants, producers, and traders in India first formalized the use of commodity derivatives for risk management and hedging purposes. In 1875, the Bombay Cotton Trade Association organized a futures market, and that system spread to other commodities in major cities across India. At the outbreak of World War II such trading ceased, but commenced again in 1952 under the auspices of the Forward Markets Commission and the Forwards Contracts (Regulation) Act. During that early period, governmental regulation was erratic and inconsistent, and the government eventually suspended trading in 1966 due to fear of price manipulation on unregulated exchanges.

In 1980, following the recommendations of the seminal report of Khurso Committee, the government reintroduced limited futures trading for several committees, including cotton, kapas, jute, and potatoes. India's embrace of economic openness in the early 1990s, including accession to General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), led to the prudential development of modern commodity trading in the country. In 1993, the government appointed Kabra Committee recommended the revival of previously banned commodity futures, as well as the introduction of new commodities such as silver. The World Bank and United Nations Conference on Trade and Development (UNCTAD) reports highlighted the benefits of futures trading as a risk management tool. A series of other domestic and international studies followed (see textbox), which collectively led to the development of a transparent, fair, and methodological legal and regulatory regime for commodity futures trading in India.

Modern commodity trading commenced in India in 2003 with the establishment of three national exchanges

Indian Commodity Market Studies

India's commodity market development reflects the government of India's sustained commitment to gradual reform consistent with international economic theory, experience, and best practices. A number of domestic and international studies informed this process, including:

Khurso Committee Report (1980)

Kabra Committee Report (1994)

World Bank & UNCTAD: Managing Price Risks with Futures Markets (1996)

World Bank: Brokerage (2000)

World Bank: Clearing House (2000)

World Bank: Improving Commodities Futures Markets (2000)

World Bank: Warehouse Receipt Systems (2000)

Guru Committee Report (2001)

The Report of the Group on Forward and Futures Markets (2001)

The Ramamoorthy Committee Report (2003)

The Report of the Inter-Ministerial Task Force on Convergence of Securities and Commodity Derivatives Markets (2003)

USAID Roadmap: Commodity Futures Market Development in India 2005 and Forward (2004)

that met stringent government criteria. In just one decade, India now boasts one of the most vibrant commodity derivatives sectors in the world. The total value of commodities traded on India's exchanges exceeded 181 trillion rupees (\$3.5 trillion) in the last fiscal year, constituting a 65% increase from the previous year.³ Metal and energy derivatives account for 88% of trading value, with agricultural commodities totaling 12%. Market participants include corporate users of agricultural products, metals, and energy, as well as small and medium size businesses that rely on exchanges for hedging and price discovery. India's largest commodity exchange, the Multi-Commodity Exchange (MCX), was a mere idea ten years ago, yet is now the third largest commodity futures exchange in the world based on total number of trades. MCX grew in trading volume by 12% in 2012, despite the global exchange traded derivatives market contracting by 15%.⁴ India's commodity sector has generated over 1.5 million jobs, and impacts the lives of millions more.⁵ India has become a global leader in commodity trading, and the development of these markets has created jobs and propels economic growth.

The Proposed CTT and its Faults

The 2013-14 Union Budget, presented by Finance Minister P. Chidambaram, proposed a tax of .01% to be levied on the sale of all non-agricultural commodity derivatives. According to Mr. Chidambaram, the CTT is based on the premise that "there is no distinction between derivative trading in the securities market and derivative trading in the commodities market."⁶ This tax, and its asserted rationale, is flawed for five economic reasons; it is also flawed for the "lessons learned" from the adverse consequences suffered by other nations that have imposed such a tax.

Securities Investment versus Commodities Hedging. The asserted premise underlying the CTT – that there is no distinction between securities and commodity derivatives' trading – fails to account for the economic functions of commodity derivatives. Securities are instruments for entrepreneurs and businesses to raise capital, and for investors to profit from the rise and fall of prices. Commodity futures' key economic function is to hedge against price risks based on the underlying physical commodity. Hedging activity reduces unforeseen, but previously existing, economic loss created by price fluctuations, and such does not yield positive profits akin to securities trading.

Commodities further differ from securities because of the essential price discovery function performed by commodity derivatives markets. Unlike the spot price for

³ Government of India, Forward Markets Commission, *Annual Report 2011-2012*.

⁴ Futures Industry Association, *FIA Annual Volume Survey 2012*.

⁵ *Study on Economic Impact of Commodity Futures Market in India – Functions and Contributions*; Deloitte, Touche Tohmatsu India Private Limited (DTTIPL) and Confederation of Indian Industry (CII); Forthcoming.

⁶ P. Chidambaram, Minister of Finance Speech Presenting Budget for the Year 2013-14, February, 28, 2013.

securities, there is no single prevailing price for a given commodity. Rather, reference prices for physical commodity transactions in India are established at hundreds of *mandis* boards and delivery centers, and through active and liquid commodity trading on exchanges by informed market participants. This trading activity serves to stabilize prices over the long-run, and reduces dramatic price fluctuations caused by unpredictable market shifts. Even speculative traders facilitate price discovery and market stability, because they increase volume and liquidity, and serve as willing counterparties to hedging transactions. Thus, because commodities and securities serve different economic functions, and traders of each have different motives, the effects of the CTT must be evaluated in the context of the commodity sector.

Market Migration and Tax Revenue. Securities market participants seek investment returns, often over long periods of time, particularly for institutional actors like pension funds and insurance companies. By contrast, commodity hedging operates in short time spans and at razor thin margins, usually just a fraction of one percent.⁷ This means that commodity traders are highly sensitive to transaction costs. Commodity exchanges in India recognize this fact, and exchanges currently charge users a low average fee of Rs. 1.6 per lakh of transactions (exchanges previously charged Rs. 5 per lakh, but had to lower their fees to make hedging viable and affordable).⁸ Under the proposed .01% CTT, total transaction costs would rise to Rs. 11.6 per lakh, greatly deterring meaningful hedging activity in addition to significantly reducing trading.

Commodity trading volume is highly elastic, meaning that even a small increase in transaction costs will significantly reduce trading volume.⁹ In the case of India's non-agricultural commodities, the increased costs via the CTT will cause traders to pursue cheaper hedging opportunities on international exchanges or through illegal and untaxable *dabba* market activity. India's hedging costs are already amongst the highest in the world, so any increase in transaction costs would almost certainly deter market activity. A large cost increase, such as that created by the CTT, would likely result in a 65-70% reduction in trading value, with some analysts predicting a 90% loss in volume.¹⁰ Such a migration of traders would effectively undermine ten years of wise government policy and concomitant remarkable commodity market development in India. Bereft of liquidity, India's national commodity exchanges would become havens for speculators with a newfound ability to extract high risk premiums from hedgers. Efficient price

⁷ Madhoo Pavaskar and Nilanjan Ghosh, "Commodity Transaction Tax: a Recipe for Disaster," *Economic & Political Weekly*, September 27, 2008.

⁸ Shreekant Javalgekar, "Tax Will Set Back Commodity Futures Market By Decades," *The Financial Express*, March 1, 2013.

⁹ George H.K. Wang and Jot Yau, "Would a Financial Transaction Tax Affect Financial Market Activity? Insights from Futures Markets," *Cato Institute Policy Analysis*, No. 702, July 2012.

¹⁰ Pavaskar and Ghosh, "Commodity Transaction Tax: a Recipe for Disaster."

discovery would become impossible, thus enabling commodity distributors, merchants, and intermediaries to gouge both consumers and producers.

Because trade volume would plummet on domestic exchanges, the CTT would yield ever less revenue. Reduced trade volume would also adversely impact other direct tax revenues currently collected from commodity brokers, day traders, exchanges, and other market participants. This revenue includes Income Taxes, Services Taxes, TDS, and Stamp Duty. Thus, the government's estimate that the CTT will generate revenue of Rs. 1500 crores is flawed because it accounts for neither the reduced trading volume caused by the CTT, nor other related lost tax revenues. Instead, the CTT will be revenue *negative* if trading volume decreases by approximately 25%. If trading volume falls by 65-70%, as some analysts project, the total annual revenue loss could exceed 1000 crores.¹¹

Impact on Small and Medium Enterprises. SMEs, such as jewelers, cable manufactures, chemical producers, textile producers, and energy using manufactures, are particularly harmed by the CTT. The CTT is by design a regressive tax, as it imposes a flat fee on transactions irrespective of the level of profit or monetary value. This means that an SME seeking to hedge a relatively small exposure would pay the same transaction tax as a large corporation trading commodities worth millions of Rupees. As many SMEs generate only a modest profit, enhanced hedging costs will threaten their sustainability. Moreover, SMEs are less likely to have access to international exchanges, meaning that many will be forced to either: stop hedging and accept greater risk; use illegal markets to hedge; or attempt to hedge on illiquid domestic markets and pay the CTT.

Loss of Jobs. According to Deloitte Consulting, India's commodity sector has generated over 1.5 million jobs, and has indirectly created or enhanced at least 1 million more.¹² Many of these jobs would be lost due the imposition of the CTT, as market activity would shift overseas and to illegal markets.

Discrimination. As currently proposed, the CTT unfairly discriminates against certain economic sectors with no policy justification, in three ways:

- *Securities versus Commodity Discrimination:* Trading a commodity product on a stock exchange (e.g., a Gold ETF) incurs a transaction charge of Rs. 1 per lakh. Whereas trading a commodity on a commodity exchange (e.g., a Gold Derivative Contract) would cost Rs. 10 per lakh. In either cases, the underlying asset is the same.

¹¹ Ibid.

¹² Ibid.

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- *Currency FX versus Commodity Discrimination:* Currency derivatives, which currently have five times the daily market turnover of commodity derivatives, are not subject to a transaction tax.
 - *Agriculture versus Metals/Energy Discrimination:* The proposed CTT applies only to non-agricultural derivative trades, even though these transactions serve the same hedging purposes as agricultural derivatives.

Empirical Evidence Worldwide

Many nations have explored transaction taxes similar to India's new CTT. These efforts were typically short-lived and fraught with unintended adverse consequences. These taxes have emerged periodically around the world for over a century, and have reentered political discourse since the global financial crisis. In general, transaction taxes have fallen out of favor as financial markets have become more computerized and global, and exchanges can readily attract foreign business by lowering trading costs. Nations now rarely elect to impose transaction taxes precisely because they have a proven negative impact on a given market's competitiveness, and will fail to generate revenue over the long-term.¹³ The following are examples of failed attempts at imposing commodity transaction taxes:

United States. In 1963, the U.S. adopted the Interest Equalization Tax (IET) as a temporary means to reduce the balance-of-payment deficit. By design, the tax made foreign securities less appealing to American investors by taxing them up to 15% of the purchase price. The immediate effect of the tax was to kill the nascent "Yankee Bond" market, through which foreign corporations issued dollar-denominated bonds. The same year, an Italian firm issued the first "Eurobond" as an alternative to the American bond, and an unregulated market quickly emerged in London. The volume of Eurobond issuances in London went from \$148 million in 1963 to \$2.7 billion in 1970.¹⁴ Today, the Eurobond market is the largest forum for fixed-income transactions, with a total annual value of \$3.7 trillion, and is centered in London. Although the U.S. eventually realized its error by repealing the IET in 1974, and Yankee Bond issuances increased, the market had nonetheless permanently shifted to London. The IET transaction tax error has cost the U.S. billions of dollars over the long-term.¹⁵

Beyond the demonstrable U.S. Eurobond fiasco, multiple studies suggests that a transaction tax would have no stabilizing effects on U.S. financial markets, but would

¹³ Wang and Yau, "Would a Financial Transaction Tax Affect Financial Market Activity? Insights from Futures Markets."

¹⁴ Schenk, Catherine, *Origins of the Eurodollar Market In London: 1955-1963*, Department of Economic and Social History, University of Glasgow, April 2002.

¹⁵ John Glover, "Eurobond 50th Anniversary Shows Tobin Tax Risks," *Bloomberg*, February 3, 2013.

instead reduce trading volume and increase volatility.¹⁶ For example, based on market elasticity, a transaction tax of .02% would cause the collapse of a variety of U.S. futures transactions, including the S&P 500 index, 10-Year T Note, British Pound, soybean, and gold futures.¹⁷ Such a tax would fail to generate significant tax revenue, and likely would drive away businesses and economic activity to untaxed foreign markets.¹⁸

Sweden. On January 1, 1984, Sweden began collecting a 1% round-trip (i.e., buy and sell) transaction tax on equity transactions, with the tax rising to 2% in 1986. By 1990, 60% of the trading volume of the eleven most actively traded Swedish share classes, amounting to 30% of total Swedish trading volume, had shifted to London. The tax raised little revenue as the loss in trading volumes caused revenues from capital gains taxes to decline, thereby entirely offsetting revenues from the transactions tax. Sweden abolished the tax in 1990, and immediately experienced an increase in domestic trading volume.¹⁹ Analysis revealed that the tax caused foreign investors to move to trading abroad, while domestic investors became less inclined to trade at all. Foreign investors still traded the same amount of Swedish equities, they merely did so in London, thus causing Sweden to lose out on brokerage fees, exchange fees, and tax revenue.²⁰

Brazil. In October 2010, Brazil began collecting a 1% to 2% tax on all exchange traded instruments traded in foreign currency. The tax immediately resulted in a large liquidity shift to the U.S. and other international markets. Open interest in Brazilian FX contracts plummeted 44%, while currency hedging activity via the Chicago Mercantile Exchange's Brazilian *Real* contract increased. In December 2011, Brazil repealed the tax, citing a desire to rekindle foreign investment.²¹

Taiwan. Since 1998, Taiwan has levied a transaction tax on stock index futures. In 2000, the government cut in half that tax rate on futures transactions from .05% to .025%, in an effort to better compete with markets in Singapore that also traded Taiwanese-based futures contracts. As a result, Taiwan trading volume increased dramatically, and by 2002, trading volume for the Taiwan Index future for the first time exceeded that of the same contract on the Singapore futures exchange. As trade migrated to the lower cost

¹⁶ C. Johan Bjursell, George H. K. Wang, and Jot Yau, "Transaction Tax and Market Quality of U.S. Futures Market: An Ex Ante Analysis," 22 *Review of Futures Markets* (2012); Robert Z. Aliber, Bhagwan Chowdhry, and Shu Yan, "Some Evidence That a Tobin Tax on Foreign Exchange Transactions May Increase Volatility," *European Finance Review* 7 (2003).

¹⁷ Wang and Yau, "Would a Financial Transaction Tax Affect Financial Market Activity? Insights from Futures Markets."

¹⁸ The U.S. currently charges a very small transaction tax of .0034%, which is designed to cover the operating costs of the U.S. Securities and Exchange Commission.

¹⁹ Steven R. Umlauf, "Transaction Taxes and the Behavior of the Swedish Stock Market," *Journal of Financial Economics* 33 (1993): pp. 227–240.

²⁰ John Y. Campbell and Kenneth A. Froot, "International Experiences with Securities Transaction Taxes," in Jeffrey A. Frankel, ed. *The Internationalization of Equity Markets*, 1994.

²¹ BIS Quarterly Review, December 2011.

market in Taiwan, the Taiwan Futures Exchange (TAIFEX) replaced the Singapore Stock Exchange (SGX) as the market leader for price discovery. The SGX also lost its information advantage over TAIFEX, and became a more reactionary and dependent market. In 2006, Taiwan again lowered its transaction tax to .01%, causing the TAIFEX's trading volume to increase by nearly 300%. In 2010, Taiwan *suspended the tax* for corporate and financial bonds.²²

Japan. In 1953, Japan introduced a securities transaction tax that reached as high as .55% by 1981. The rate was lowered to .30% in 1989, before being *completely eliminated* in 1999 as part of Japan's "Big Bang" economic liberalization. In every instance, the tax reductions enhanced market volume by attracting foreign capital. Japan recognized that the tax had not raised revenues and had diminished market liquidity.²³ Moreover, at the lower tax levels, Japanese markets responded quicker to new information, suggesting that the price discovery process was more efficient.²⁴

Europe. In 2013, the European Parliament is considering a Pan-European harmonized financial transaction tax, to commence in 2014. Britain, Sweden, and Luxembourg oppose it unless it is worldwide, because of the likely market migration.

Canada. A Bank of Canada study in 2012 examined many FTT taxes worldwide. It concluded that such taxes generally, and in varying degrees, decrease market liquidity, increase volatility, decrease investment, and lose jobs.²⁵

Conclusion

The Government of India should avoid the CTT. Such a commodity transaction tax would: significantly harm the hedging and price discovery economic functions of commodity derivatives; result in a loss of jobs in the entire ecosystem associated with the existence of vibrant commodity futures markets; unfairly apply false policy analogies; derail India's international commodity derivatives leadership status; ignore the lessons of other nations' foolishness; and raise no money.

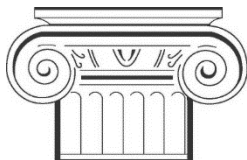
Fortunately, the "unintended consequences" of this transaction tax are foreseeable. Follow the *Arthashastra*.

²² Robin K. Chou and George H. K. Wang, "Transaction Tax and Market Quality of the Taiwan Stock Index Futures," *Journal of Futures Markets* 26, no. 12 (2006); Wang and Yau, "Would a Financial Transaction Tax Affect Financial Market Activity? Insights from Futures Markets."

²³ Shvedov, Maxim, *Transaction Tax: General Overview*, CRS Report for Congress, U.S. Library of Congress, December 2004.

²⁴ S. Liu, "Securities Transaction Tax and Market Efficiency: Evidence from the Japanese Experience," *Journal of Financial Services Research* Vol. 32, No. 3 (2007)

²⁵ Bank of Canada Review, "Financial Transaction Taxes: International Experiences, Issues, and Feasibility," Autumn 2012.



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