Transaction Taxes Harm Commodity Futures Markets

Abstract

The Government of India's proposed transaction tax on commodity futures trading is likely harmful to India's economy. This report illustrates the experience around the world (New York, Japan, Taiwan, etc.) which shows conclusively that transaction taxes in financial markets hurt local economies. Typically, these taxes adversely impact markets liquidity, impair the price discovery function, cause a significant loss of trading volume to competing overseas exchanges or to underground activity, and secure no real gain in revenues. India's commodity futures markets are no exception to this rule, and these markets in India are both highly successful, and yet fragile because so new. No new commodity transaction tax should be implemented.

Charles M. Seeger is Chairman and CEO of Financial Markets International (FMI), a law and economics consulting firm in Washington, D.C. He directed the Government of India requested USAID Commodity Futures Markets Development Project. He was formerly Senior Vice President and Counsel for the Chicago Mercantile Exchange.

Financial Markets International, Inc. (FMI) is a U.S. based international consulting firm that specializes in assisting countries to develop sound and efficient capital markets. FMI has worked in over 35 countries with the U.S. Agency for International Development (USAID), World Bank, Asian Development Bank, and private securities and commodities exchanges and banks since 1992. www.fmi-inc.net

FMI Research Associate Christopher Thompson served as a contributing writing and research analyst for this article.

Purpose of Report

This report offers a review of experience around the world that demonstrates that transaction taxes in financial markets hurt local economies. It also demonstrates that these taxes reduce trading volume, adversely impact liquidity, impair the price discovery function, cause a significant loss of trading volume to competing overseas exchanges, and secure no real gain in revenues.

The Government of India's (GOI) proposed Union Budget (2008-2009) presents a plan to impose a transaction tax on commodity futures trading. This report recommends that the GoI rescind this transaction tax for the foreseeable future so that India's commodity futures markets continue to develop and better serve the risk management and price discovery functions so helpful to agricultural producers and commodity end-users.

Overview of the Proposed Transaction Tax

The GOI's proposed tax seems small, ranging from 0.017% to 0.125% of the underlying value of the commodity futures transaction. Yet, this is an 800% increase in transaction costs. This comes at a time when India's commodity futures markets are only four year old, with relatively low transaction costs, and are estimated to exceed 50 trillion rupees (US$ 1.2 trillion) this year, a record. Let them prosper.

India's rationale for levying a higher transaction tax focuses on three perceived social benefits: a need for government revenue; neutrality in government policy towards the securities and commodity futures markets; and better information tracking for tax compliance. None of these supposed benefits are likely.

Previous Transaction Taxes in Financial Markets Around the World

When a government imposes a transaction tax on financial markets, the result is typically a loss of business to foreign exchanges and a decrease in revenues to the government. Such was the case in the United States markets in the 1960s, Japan in the 1990s, and Taiwan in the 2000s.

In the early 1960s, New York was the center for Eurobonds, an international bond that is denominated in a currency not native to the country where it is issued. In 1963, the U.S. imposed a tax on foreign borrowing in U.S. capital markets to help finance the country's growing intervention in Vietnam. As a result, the market for Eurobonds shifted from New York to London. The volume of Eurobond issues in London went from US$ 148 million in 1963 to US$ 2.7 billion in 1970 - - an 1800% increase for London.[1] The center of Eurobond trading did not return to New York, and jobs were lost, and the tax revenue generated for the U.S. Government declined steeply. This experience influenced U.S. policy makers to cautiously approach transaction taxes on securities or commodity futures markets.

In 1987, Japan imposed a transaction tax on securities and commodity futures ranging between 0.3% and 1% of the transaction's full value. At first, the tax generated 4.2% of the Government of Japan's general account revenue in 1988, but by 1993 the revenue share had fallen to .96% of the general account revenue.[2] Why? Because of the shift in market volume to less-taxed, offshore locations. Japan then removed the transaction tax, recognizing that it had not raised revenue and had diminished its market's liquidity.

Taiwan imposed a transaction tax of 0.05% 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%, and in 2005 furthered reduced it to 0.01%.[3] TAIFEX's volume then jumped from 31.87 million contracts in 2003, to 92.66 million contracts in 2005.[4] The competitive advantage enjoyed by the SGX diminished, and trading shifted back to

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[1] Schenk, Catherine. Origins of the Eurodollar Market In London: 1955-1963. Department of Economic and Social History. University of Glasgow. April 2002.
[2] Shvedov, Maxim. Transaction Tax: General Overview. CRS Report for Congress. U.S. Library of Congress. December 2004.
[3] Grede, Frederick. Taiwan: A Closer Look. Futures Industry Magazine. January/February 2006.
[4] Chou, Robert, and George Wang. Transaction Tax and Market Quality of the Taiwan Stock Index Futures. National Central University of Taiwan, and George Mason University of U.S. May 2006.

Taiwan. Taiwan's revenue generated by the transaction tax declined immediately after the reductions, but three years later, the increase in volume had caused revenue to exceed previous levels.

This story repeats itself. In recent decades, many countries have reduced, or completely eliminated, their commodity futures transaction taxes and securities transaction taxes. A University of Massachusetts's study[5] found that of 38 countries with transaction taxes on securities and futures, 17 have reversed their policy, and reduced or removed the taxes.

While it is true that sound regulation is an important confidence building tool for financial markets, it is also true that the burden of financing a financial regulator should not be borne solely by the market participants. Sound markets are a national asset. To ensure impartiality in regulation, regulators should be independent of the markets they regulate, not financially dependent. Regulators desperate for budget revenue can be tempted to strangle the proverbial goose that lays golden eggs.

Commodity Futures Markets Differ From Securities Markets

The second rationale, neutrality with the securities markets, is also misguided. There are vast differences between securities and commodity futures markets. India's modern securities markets are robust and well established, having existed for a decade and a half. Not until 2004, after a ten year maturation, did the GOI impose a securities transaction tax. And that securities tax was accompanied by an elimination of the corporate gains tax, which lessened the impact of the transaction tax on securities exchanges.

India's modern commodity futures markets have only existed for four years. They are too nascent to be overburdened by a transaction tax. They are also one-fifth the size of the securities markets, and trade in only a single product type, futures. Commodity futures trading in India is already subject to an overabundance of taxes.

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[5] Baker, Dean, Robert Pollin, and Mark Schaberg. Securities Transaction Taxes for U.S. Financial Markets. Political Economic Research Institute. University of Massachusetts Amherst. 2001.

These include mandi fees, sales tax / VAT, excise, customs, and octroi. Securities, on the other hand, are not subject to any of these taxes.

The third rationale for the transaction tax on commodity futures, that such will enable better information for tax compliance, is false. India's multi commodity exchanges are electronic, have world class surveillance systems, and maintain a complete audit trail. All trade statistics are already provided to the FMC by the end of each trading day. A transaction tax on commodity futures will not improve the highly transparent system already in place.

Likely Outcomes of the Proposed Transaction Tax

In short, not only do the presumed benefits of the proposed tax fail upon close examination, there are several serious disadvantages to Indian farmers that would result.

One likely outcome of high transaction taxes on commodity futures is the impairment of the price discovery function. Market participants guide their decision making about investments or agricultural production by seeking reliable information on future prices. Any decrease in liquidity lessens the efficiency and accuracy of discovery of price information.

In India, where agriculture accounts for a majority of livelihoods, a distortion of price discovery would disproportionately harm farmers. Indian farmers use the country's commodity futures markets to find the best price available for their produce, and to make decisions regarding planting, harvesting, and crop storage. They use this price information *even if* they do not trade futures.

Further, in this era of electronic trading, the cost of trading can readily cause business to transfer to overseas platforms, or more likely go underground and unregulated and non-transparent. The exit of liquidity providers means decreased efficiency of the futures markets, more volatility, and less facility for other market participants to make effective use of futures markets.

India's commodity futures transaction costs are now competitive with the rest of the world, and this has been a factor in the spectacular growth of the Indian commodity futures markets. Low transaction costs make markets affordable and accessible. This allows market participants to execute additional trades, increases volume and liquidity, and encourages an ever greater number of potential participants to enter the market.

Conclusion

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 have growing commodity futures markets. If the Indian transaction tax is passed, these foreign markets will gain the jobs, wealth, and foreign investment that would have otherwise been India's. History teaches: New York's Eurobond loss to London will be Mumbai's loss to Shanghai or Singapore.

The former Chairman of the Chicago Mercantile Exchange and international futures markets genius, Leo Melamed, warned the U.S. Congress a quarter century ago that taxes on commodity futures were "a giant step in the *opposite direction* of lessening the burdens of regulation." Taxing and destruction are often dangerous companions.

Charles M. Seeger
Chairman & CEO
Financial Markets International, Inc.
www.fmi-inc.net
cseeger@fmi-inc.net