OPINION

India's Commodity Folly

By Charles Seeger

In February, against all basic economic sense, Indian Finance Minister Palaniappan Chidambaram announced a new tax on commodities futures trading as part of his 2013-14 national budget. Should it pass, the tax would apply to all non-agricultural items, including copper and natural gas.

India's commodity futures market, just an idea in 2003, has become one of the world's leading exchanges in precious metals and energy, with a total turnover of 181 trillion rupees ($3.35 trillion) in the 2011-12 fiscal year. Mr. Chidambaram's transaction tax would cripple the hedging and price discovery functions of this market. It would also cause job losses across India's commodity trading network—all for little budgetary gain.

> A transaction tax won't extract much revenue from futures exchanges—because it will quickly cripple them.

Mr. Chidambaram justifies his proposal by saying that the plan raises needed revenues, and that it is only fair to tax futures derivatives in the same manner as securities. He is wrong.

Securities are instruments for businesses to raise capital and for investors to profit from the rise of prices. In contrast, commodity futures' key function is to hedge against the price risks of an underlying physical commodity. Such hedging does not yield profits akin to securities trading. Instead, it functions as insurance, reducing economic losses created by price fluctuations.

Commodity futures also provide an essential price discovery function. There is no single prevailing price for a given commodity. Rather, reference prices for commodity transactions in India are established at thousands of spot markets in village and city delivery points, as well as on commodity exchanges.

Exchange trading reduces price fluctuations, and even speculative traders facilitate market stability because they increase liquidity and serve as willing counterparties to hedgers. A tax on this system will decrease trading, reduce liquidity, widen spreads and impair the efficiency of price discovery and hedging.

India's finance minister should know this, just as he should know that other countries' attempts to generate revenue from transaction taxes have failed. The reason is simple. Modern commerce is computerized and global. When taxes hurt a market's competiveness, money flows to exchanges with lower trading costs.

There are many examples of this dynamic at play. In 2010, Brazil began collecting a 1% tax on all exchange-traded instruments traded in foreign currency. The dollar value of foreign exchange contracts traded in Brazil plummeted 44%, while Brazil currency hedging activity in U.S. markets increased dramatically. In December 2011, Brazil repealed the tax, citing a desire to rekindle foreign investment.

Sweden began collecting a 1% tax on equity transactions in 1984. By 1990, 60% of the trading volume of the most actively traded Swedish shares had shifted to London. The loss in trading volumes caused revenues from capital gains taxes to decline, thereby offsetting any revenues from the transaction tax. Sweden also lost out on brokerage fees, exchange fees and jobs until it reversed course in 1991.

In 1963, the U.S. adopted a temporary transaction tax on foreign bonds at a sliding percentage of face value. This was intended to make foreign securities less appealing to American investors. The immediate effect of the tax was to kill the nascent "Yankee Bond" market through which foreign corporations issued dollar-denominated bonds.

Instead London investment bankers created the "Eurobond." The market for dollar-denominated securities rocketed to $2.7 billion in 1970 from $148 million in 1963. Today, the Eurobond market is still centered in London, and the U.S. has lost the equivalent of London's Canary Wharf district in fees, jobs and real estate.

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Indian Finance Minister Palaniappan Chidambaram.

Transaction costs matter because markets can migrate away. Recognizing this, Indian commodity exchanges today charge a low average fee of 1.6 rupees per 100,000 rupees of transactional value. Under the proposed commodities futures tax, total transaction costs would rise more than seven-fold, greatly deterring trading. Furthermore, by exempting agricultural commodities the tax discriminates against businessmen in other fields such as chemical production and textile manufacturing.

Until now, India has pursued a measured path of commodity derivatives regulation, and a reliable legal regime helped the country's commodity futures markets grow. This industry of commodity exchanges, commercial hedgers, traders and service providers accounts for more than 1.5 million jobs—jobs that are now endangered by a levy that will fail to generate significant revenues once transaction costs scare away business. New Delhi should scrap the tax before the damage is done.

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