# Commodity transaction tax not a prudent idea

The commodity transaction tax (CTT) was proposed in Union Budget 2008-09 and withdrawn in July 2009-10, following the recommendations of the Prime Minister's Economic Advisory Council. In the wake of a raging debate in the media and demands from certain groups on imposing transaction taxes on commodity derivatives, it seems pertinent to revisit the importance of commodity derivatives markets and impact of CTT on them.

Pure economic logic reveals that the potential benefits of CTT will definitely be outweighed by the costs of its levy. Axiomatically, commodity exchanges are supposed to reduce transaction costs associated with finding buyers and sellers. Functionally, such institutions are supposed to promote efficiency in production, planning, storage and marketing through price discovery and hedging functions. Both price discovery and hedging functions are contingent upon volumes and liquidity.

If the idea of a CTT has been conceived to generate revenues, discourage speculative trading and reduce volatility, it needs to be unveiled that the idea is misplaced. This is because the efficiency of this hedging platform is an inverse function of the cost of transacting on it. It needs to be reiterated here that the objectives of garnering revenues and reducing speculation are contrary to each other. CTT, by increasing cost of transactions, will dent short-term transactions. With such 'crowding out' of short-term volumes, there can be losses in incomes and concomitant tax collections, which might even outweigh the expected revenues from CTT.

Again, such reduction in market liquidity will increase the bid-ask spread, a major component of transaction costs. This will increase the price volatility, with potentially cascading destabilising impacts on the physical markets. Again, by increasing the cost of participation, CTT will also shift trading volume either to the overseas markets or to the illegal markets, which are relatively low-cost destinations.

It is a double-whammy for hedgers as CTT will increase both the direct and indirect costs of hedging. While directly the cost-incidence will increase in proportion with amount of tax imposed, there will be an indirect cost, too.

This will be in the form of higher risk premiums to speculators, due to reduction in volume, increasing the aforementioned bid-ask spreads. As such, hedging instruments like commodity derivatives are extremely sensitive to costs of transactions. A study in China has revealed that an increase of 0.2 percentage points in stamp duty reduces the trading volume by a third. Similar evidences are available in other hedging markets like forex and interest rate derivatives.

According to a study by Icrier, the proposed CTT of 0.017% in the 2008-09 Budget (which was withdrawn in the next Budget) was supposed to increase the transaction costs by more

than 950%. The study examined the relationship between volume, volatility and transaction cost for five selected commodities — gold, copper, petroleum crude, soya oil and chana. It inferred a negative relationship between transaction cost and liquidity, and a positive relationship between transaction cost and volatility, similar to results found in hedging platforms worldwide.

Two other arguments are also forwarded by the proponents of CTT, without any basis. It is argued that future trading creates inflationary pressure in the economy as the speculators use liquid markets to manipulate prices, and, in this way, harm both producers and consumers. The ICRIER study finds that futures trading does not cause inflation, rather it brings efficiency in these markets.

A study by the IIMB observes that the causes of commodity inflation in India were supply side factors, combined with the government policies. Similar views were expressed by the Abhijit Sen Committee in 2008. The committee was of the view that future markets, rather than creating inflationary pressure in the economy, help discover prices and integrate markets spatially and temporally.

The second argument is that CTT can work as an anti-tax evasion measure. It can help in tracking information for better tax compliance. It should be noted that all national commodity exchanges have world-class surveillance systems with proper auditing. Therefore, for suppressing fictitious trading, the need is to give teeth to the FMC rather than imposing CTT. Transparency in commodity future markets depends on information symmetry and level of infrastructure.

Increase in transaction costs due to increase in taxation leads to decrease in trading volume in the security exchanges also. Evidences from the Tokyo, Shanghai and Shenzhen markets validate this finding. A study examining the impact of increase in security transaction tax from 0.1% to 0.125% in India finds that as a result of this increase in taxation the traded volume declined by 25%, though the impact on the volatility of returns remains inconclusive. No doubt, CTT will reduce the competitiveness of Indian commodity markets, making the economy bereft of a low-cost risk management platform in non-agricultural segments like bullions, base metals, energy, etc, potentially rendering many SMEs (who are direct and indirect beneficiaries from the commodity exchange platforms) 'unproductive' in the process. The need of the hour is to bring in vibrancy in commodity markets as vibrant markets give signals about the future state of the markets and economy.

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*(Financial Express)*