

# From Turnover Taxes to GST: Why CTT is a Bad Idea?

A decorative graphic on the left side of the slide, consisting of a vertical black line intersecting a horizontal black line. To the left of the intersection are three overlapping squares: a blue one on top, a red one on the left, and a yellow one on the bottom.

M. Govinda Rao

A decorative graphic on the left side of the slide, featuring overlapping squares in yellow, red, and blue, with a vertical black line passing through them.

# Scheme of Presentation

- Why do we need a GST? Important principles of commodity taxation
- Reform in Domestic Trade Taxes in India: Progress so far and Roadmap to GST.
- Measures towards GST in the 2008-09 Budget.
- The introduction of CTT: Objectives.
- Impact of CTT on Commodity Futures.
- Conclusions



# Why GST ?

---

- Turnover Taxes or taxes on transactions are distortionary. They have differential relative price impact on different commodities. GST is neutral between different goods as well as services.
- Turnover taxes increase transaction costs of conducting businesses and this varies between different goods and services.
- Turnover taxes are non-transparent.
- Self policing feature; Incentive to formal markets; Tax on informal trading; Information generation;

# Reform of Domestic Trade Taxes



The Proposal to Introduce GST in 2010: Need to prepare the Central and State tax administrations for the levy of GST.

- The Important Tasks are:
  - Determining the revenue neutral rate.
  - Administrative arrangements for the dual VAT.
  - Mechanisms to phase out CST.
  - Mechanisms to share tax powers on services with States.
  - Instituting an administrative organization and efficient information system.
  - Specific reforms by the central government such as (i) Convergence of rates within goods; (ii) General taxation of services; (iii) Convergence of threshold and rate between goods and services (iv) Treatment of sumptuary excises and (v) removal of all other taxes on transactions.
  - Specific reforms at the state level such as (i) phasing out CST; (ii) Concurrent tax on services (iii) merging all other consumption and turnover taxes.

# Progress of GST in Budget 2008-09

Very few positive measures.

- Reduction in CENVAT rate to 14%.
  - Increase in the threshold for service taxation.
  - Proposal to reduce the CST to 2%.
  
- Expansion of the service tax base on three services (asset management service under ULIP; services of stock/commodity exchanges; right to use goods where VAT is not payable and customised software).
- Introduction of CTT : A retrograde move. At a time when the need of the hour is to minimize the transaction cost, help the development of futures market, the introduction of the tax comes as a surprise as much as a disappointment.

# Commodities Trading Tax: Some Features



“Transaction in commodity futures have come of age. Hence, I propose to introduce CTT on the same lines as STT on options and future” (Para 179 of Budget Speech of the Union Finance Minister.

- Three Propositions:
  - Transaction in commodity futures have come of age;
  - STT is something desirable from the viewpoint of revenue and market development.
  - Security transaction is equivalent to commodity transactions and therefore, the levy of CTT is akin to ST and therefore CTT is desirable.

# Commodity Futures: Some Features.

- Commodity Futures market is relatively of recent origin – just four year old. Has done significant progress in terms of turnovers, but still nascent. The turnover in commodity futures increased from Rs. 16,37,345 crores in 2005 to Rs. 34,84,485 crores in 2006 and stagnated at Rs. 36,54,487 crores in 2007. The slow down in the turnover was mainly due to the ad hoc policies. growth of futures index at 8% is lower than the international indices
- It is a market only for a single product – futures (no options, no index futures, no intangible futures) and restricted to only traders and corporate (no banks, mutual funds, FIIs).
- Commodity Futures market is plagued by ad-hoc policies. The government is still not clear about its role. Banning the forward trading in essential commodities as a measure to contain inflation from time to time is one such move.

# What Does Commodity Futures Market Do?

A decorative graphic on the left side of the slide, featuring overlapping yellow, red, and blue squares with a black crosshair.

- Main functions of Commodity Futures Market are:
  - It provides an efficient platform for price discovery;
  - Provides a platform for risk management.
  - Hedging platform for producers of various commodities.  
Provides information to help producers to make informed investment decisions.
  - Helps to extend the formal markets.

# Why Transaction Taxes?



The reasons advanced are:

- ~~Revenue: But revenue implications are negligible.~~
- Reduced volatility; On the contrary they contribute to greater volatility.
- Create an audit trail: We do not need a tax for that.
- What are its harmful effects?
  - Taxing turnovers and transactions discriminate between different commodities and services and alter relative prices in unintended ways. They impact on the way in which businesses are conducted.
  - They enhance the transaction costs and informational inefficiency.
  - They hinder the formalization of informal markets and help the formal markets to go informal.
  - Given the lower transaction costs globally, the commodities derivatives market will shift to other countries. Hindering market development is not conducive for growth.
- For these reasons, STT is as desirable as CTT.



# Are SDM and CDM Equivalent?

---

- SDM and CDM are fundamentally different. SDM is meant of making capital gains whereas CDM is meant for price discovery and risk management.
- SDM is mainly based on local stocks whereas CDM is based on global assets. Indian stocks are traded mainly in Indian exchanges whereas, commodities can be traded globally. The Indian commodity exchanges will have to provide globally competitive environment. Higher transaction cost in India could mean that trading could shift to New York or Chicago, Tokyo or Shanghai depending on where the transaction costs are lower. The levy of CTT significantly reduces competitiveness.
- The fact that SDM is taxed does not mean that CDM should be taxed. Two wrongs do not make one right. The case is for abolishing the STT and not creating an additional distortion through the CTT.



# Concluding Remarks

---

- A growth oriented tax system should both reduce the cost of operating in the formal sector and increase the cost of operating in the informal sector.
- GST ranks high in the above respect. Both STT and STT encourage informal businesses and add transaction costs to formal businesses. This is particularly true of farm products. Forward markets in these are subject to ad hoc policy regime as well.
- According to the recent World Bank publication, *Paying Taxes 2008*, India rests near the bottom – 165 out of 178 countries with respect to costs of formal businesses of complying with the tax system. If we are serious about growth we will have to change the way we think about our taxes.