

Financial transactions taxes: a puzzle

Susan Thomas

April 22, 2008

Securities Transaction Tax – STT

- Tax on transactions involving financial securities: equities, bonds, derivatives contracts.
- The tax could be a flat charge or a fraction of the value traded; equal across all assets or with different rates across different securities.
- What is common to all transactions tax?
They are bad tax policy from the public finance perspective.
- Public finance theory will agree that any tax on turnover is bad tax policy.
Typically tax targets “income earned” or “value added”, not turnover.

STT in India

- India has a substantial scale of taxation of turnover.
- For example, in the equity market, the list of charges on transactions are:
 - Stamp duty,
 - Registration charges,
 - Regulatory charges,
 - STT on spot equity,
 - STT on equity futures and options,
- Now we have additionally introduced “CTT”, taxes on commodity futures transactions.
- All of these are charges on transactions.
- Most of these are deeply entrenched.
The active effort was spent on getting rid of excise and shifting to VAT.
This has not translated to an active policy debate on removing securities transaction charges.

Should we bother?

- The transactions charges listed above sound small: 0.2 basis points of stamp duty, 25 basis points on spot, 1.7 basis points on futures.
- However, they add up to significant costs of trading on the market.
- Financial market development has been a major feature of economic reforms over the last 15 years.
- The goals of financial market development are *efficient prices* and *resilient liquidity*.
The single most important control variable to achieve this, that has been identified in the financial literature, is *transactions cost*.

Should we bother?

- The transactions charges listed above sound small: 0.2 basis points of stamp duty, 25 basis points on spot, 1.7 basis points on futures.
- However, they add up to significant costs of trading on the market.
- Financial market development has been a major feature of economic reforms over the last 15 years.
- The goals of financial market development are *efficient prices* and *resilient liquidity*.
The single most important control variable to achieve this, that has been identified in the financial literature, is *transactions cost*.
- The lower the transaction costs, the more liquid the market.
- The more liquid the market, the more efficient is market pricing.
- Bringing STT into markets is retracting all the hard work in reforming markets to make it a credit place for resource allocation both by local and international investors.

Why not remove STT?

- In the checklist of “for” and “against” transaction taxes, the answer is clearly against transaction taxes:
 - “Against” from taxation policy
 - “Against” from financial market development
- Then why keep it on?

Why not remove STT?

- Extremely lucrative source of revenues.
As of December 2007, STT revenues alone was around Rs.60 billion.

Why not remove STT?

- Extremely lucrative source of revenues.
As of December 2007, STT revenues alone was around Rs.60 billion.
- Rather attractive politically: the polity and much of the public perceives financial market places as dens of “excesses” – excessive trading, excessive volatility, excessive wages earned. Transactions taxes have been considered one way to “correct” for these “excesses”.

Why not remove STT?

- Extremely lucrative source of revenues.
As of December 2007, STT revenues alone was around Rs.60 billion.
- Rather attractive politically: the polity and much of the public perceives financial market places as dens of “excesses” – excessive trading, excessive volatility, excessive wages earned. Transactions taxes have been considered one way to “correct” for these “excesses”.
- However, the empirical evidence is that transaction taxes tend to increase rather than decrease volatility.
The “excesses” increase with transaction taxes.
- The only reason to keep transaction taxes in place: good source of revenues.

The puzzle

- Is there a way to keep the good parts of financial sector taxation (ie, revenues) and removing the bad parts (ie, remove distortionary effects on financial service production, and outcomes of financial markets)?

Going back to the basics

- The question of taxing turnover needs a three-part analysis:
 - 1 Optimal public finance policy
 - 2 Staying on track of improving financial market efficiency and liquidity.
 - 3 Recognising the globalisation of financial services and products.

Will we find an answer?

- Broadly speaking, yes.
For example, India and customs duties, in the mid-1980s. We could've taken the pessimistic attitude that it would be impossible to do away with customs.
Today, it is increasingly a thing of the past.
- Parts of the answer are already in the public/policy debates - the first steps have begun with improvements in tax policy and administration for both income tax and GST.
If the GST is extended to include finance, that would be a logically consistent approach to taxing financial services, which would achieve the goals of:
 - Being non-distortionary on how financial services are produced.
 - Being non-distortionary on how financial market perform, **and**
 - Tap revenues from the financial sector.