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India's Commodity Transaction Tax (CTT), What Impacts on Commodity Futures Exchanges?

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In an apparent policy u-turn, New Delhi has deferred the official notification that will pave the way for the implementation of the long-awaited commodity transaction tax (CTT) in India. The official notification was expected on June 1, 2013 so as to enable commodity futures exchanges to undertake necessary changes in the trading system before its due implementation from July 1.

Till now, the Finance Ministry has not communicated the reasons for undue delay in issuing of notification. Meanwhile, media reports suggest that the CTT could only come in effect from October 2013 while some market participants are confident that this tax may not see the light of the day. Amid widespread confusion, the CTT's future hangs in the balance.

The Commodity Transaction Tax

In February 2013, Finance Minister P Chidambaram had proposed a transaction tax on the commodity futures trading as part of the Finance Bill 2013-14. As per the proposal, the CTT would be levied at 0.01 percent (Rs.10 for transaction worth Rs.100000) and only on non-agricultural commodities futures contracts (e.g., gold, copper and oil) traded in the Indian markets. While the agricultural futures contracts would be exempted from CTT. The tax will be payable by the seller of futures contract.

Despite strong opposition by traders, the Finance Minister did not withdraw the CTT proposal or reduced the tax rates in the Finance Bill. The CTT proposal was passed by Parliament and the Presidential assent was received on May 10. It was expected that the government will issue a notification to make CTT operational by July 1.

The Finance Minister's rationale for introducing a CTT was to bring commodity market on par with the securities market where a securities transaction tax (STT) is levied. In his Budget speech, Mr. Chidambaram stated, "There is no distinction between derivative trading in the securities market and derivative trading in the commodities market, only the underlying asset is different. It is time to introduce CTT in a limited way."

It is difficult to accept that the delay is caused by purely procedural issues because the revised rates of STT – listed in the Finance Bill – have been implemented with immediate effect. The National Stock Exchange is levying a lower STT of 0.01% on equity futures from June 1, 2013.

Twice Thwarted

It is not the first time that the UPA government has abandoned plans to implement a commodity transaction tax. In the Budget 2008-09 too, a CTT of 0.017 percent (much higher

than the current tax proposal) was proposed by Mr. Chidambaram. However, due to strong apprehensions expressed by the Prime Minister's Economic Advisory Council coupled with intense corporate lobbying by commodity traders, the CTT was not implemented and subsequently withdrawn in the next Budget.

In the current scenario, it is highly unlikely that the CTT proposal duly passed by the Parliament would be implemented at all given the intense lobbying by commodity exchanges, traders and their lobby groups against the tax. Just weeks before the Budget, a multi-million rupee advertisement campaign against the CTT was launched by lobby groups to ward off any attempt to introduce such a tax. The lobby groups issued full page advertisements in national dailies and conferences to influence policymakers and public at large against the CTT.

There is enough evidence to believe that the government is apparently backing away from the implementation of CTT due to tremendous pressures exerted by commodity traders. This episode offers an interesting case study to learn how special interest groups disproportionately influence the implementation of legislative decisions in India.

The Potential Revenue Loss

By delaying the implementation of CTT, the government is losing a reliable source of new tax revenue. Based on the current trading value of non-agricultural commodities in the Indian commodity exchanges, a back-of-the-envelope calculation suggests that the CTT could fetch Rs.15950 million ($290 million) to cash-starved exchequer every year. In other words, the government is suffering a revenue loss of Rs.50 million per day due to delay in the rollout of CTT. This is a substantial amount in the present times when our tax revenues are under severe pressure and the government's attempts to reduce fiscal deficit through other measures are not yielding positive results. How the government will compensate this potential revenue loss is a moot question.

New Delhi could use a part of this tax revenue to reduce the fiscal deficit. A portion of proceeds of CTT could be potentially utilized to enhance the regulatory and supervisory capacities of the Forward Markets Commission (regulatory authority for commodity futures market) which is grossly understaffed and underfunded. A part of proceeds could also be deployed to install ticker boards at local markets across the country displaying commodity futures prices. This would help farmers and producers to access information on a real-time basis in their local languages and benefit from the futures price movement.

The Myriad Benefits of CTT

With the implementation of CTT, the government can track the flow of illicit money which is finding its way into the commodity futures markets. Currently, large information gaps exist and a centralized database of money flows into commodity markets is almost nonexistent. To a large extent, market participants have opposed the CTT because audit trail could reveal sources of funds.

Besides, the CTT would be a more efficient revenue source than other taxes as it would be collected by the commodity futures exchanges from the brokers and passed on to the exchequer, thereby enabling the tax authorities to raise revenue in a neat, transparent and efficient manner. Furthermore, the CTT should be viewed in the broader context of innovative financing for development, a concept introduced at the UN conference in

Monterrey in 2002.

Market Fears are Exaggerated

The fears expressed by commodity traders that the CTT would lead to a drastic fall in the futures trading volumes are grossly exaggerated. Given the huge profit opportunities and risk appetite among the trading community, a small levy of 0.01 percent would be quickly absorbed.

In large part, the CTT would affect speculators and day traders who often use high-frequency trading to transact a large number of futures contracts at very fast speeds. For such market participants, commodity futures markets are purely profit-maximizing platforms. However, the CTT is unlikely to hit genuine hedgers – consisting of producers, processors and consumers of the underlying commodity – due to their limited participation in the Indian markets. A small increase in the transaction costs due to CTT would not lead hedgers to flee since they primarily use commodity futures markets for price risk management purposes. On the contrary, such market participants may welcome a CTT if it enhances market stability and integrity.

Further, it would be erroneous to assume that a tax of 0.01 percent would alone shift commodity futures trading (worth $3000 billion) to illegal platform ("Dabba" trading). The opponents need to recognize that Dabba trading in commodity futures has mushroomed across the country over the past ten years in the absence of any commodity transaction tax.

Another widespread fear that the CTT would lead to migration of futures markets to offshore markets is grossly exaggerated. No international exchange can trade in Indian commodity futures contracts without a license from domestic commodity exchanges and approval from FMC.

Undeniably, a levy of 0.01% alone cannot fix the myriad problems plaguing the Indian commodity futures markets. Therefore, the CTT should be used in conjunction with other measures (such as strengthening the regulatory capacity of FMC, segregating hedgers and speculators, and encouraging greater participation of farmers and hedgers).

Nonetheless, the unexplainable delay in the rollout of CTT has further strengthened the widespread impression that the government buckles under pressure from speculators and high-frequency traders.

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