January 30, 2017 | Saurabh Chandra (http://www.infracircle.in/author/saurabhchandra/)
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Why finance minister should repeal Commodity Transaction Tax

The intent behind setting up of commodity exchanges was to provide a platform for price discovery and risk management.

On 1 February 2017, the annual budget for the financial year 2017-18 will be presented. It provides an opportunity to do away with the Commodity Transaction Tax (CTT) for having impeded the growth of the formal commodity markets.

CTT was introduced in 2013 on non-agricultural commodities at the rate of .01% payable by the seller. It was based on the assumption that there was no difference between derivatives in securities market and commodity market, apart from the underlying assets. This assumption is flawed and ignores the basic difference between the function and purpose for setting up of stock exchanges and commodity exchanges. An earlier attempt to introduce it in 2008 was dropped in the face of criticism. MCX which had, at different times 80- 90% of the share of the commodity market, was worst affected by imposition of this tax, since about 95% of its turnover was on account of trade in non-agriculture commodities. On the other hand, NCDEX's entire turnover being attributable to trade in agriculture commodities remained largely unaffected. However, NCDEX failed to capitalise on this opportunity to increase its market share.

The intent behind setting up of commodity exchanges was to provide a platform for price discovery and risk management. Unlike securities, commodity derivatives are not an instrument for savings and investment, but meant primarily for discovering the price of the underlying commodity and hedging of risk. In addition, the commodity markets are expected to benefit farmers by integrating the spot market with the derivatives market, create jobs, formalise commodity transactions and bring back commodity traders from offshore locations to local markets.

CTT by adding to the transaction costs lowered trade volumes and impeded the growth of the Indian commodity markets prior to attaining maturity. A ready reckoner to measure this is by making inter country comparisons using the annual turnover to GDP ratio. At less than 50%, India lags behind China (198%) and USA (239%). A high transaction cost further disincentivised tepid institutional participation, whose continuing disinterest could be the result of a lack of variety in the products which can be used for hedging risks, such as options and index futures.

The imposition of CTT led to a steep fall in trading volumes. This was unexpected and upset revenue receipt calculations. Neither was the objective of reducing market volatility achieved. As liquidity dried up, a body blow was dealt to the emerging commodity markets. During 2013-14, transaction cost increased by 166% whereas volumes fell by 41%. In addition it led to the following unintended, but undesirable outcomes:

- Volumes were driven from Indian exchanges to other exchanges like Dubai and Singapore; and

- Dabba trading was incentivised, as trade shifted from the formal to the informal sector, giving a boost to the parallel economy

In the wake of stagnating volumes, the commodity markets are eagerly awaiting the launch of Options trading. However, transaction taxes will make options trading a non-starter. An example of a put (buy) option on a 1kg gold contract will demonstrate this. The likely taxes payable by the buyer of a put option on a 1kg gold contract with an underlying future value of Rs.30 lakh are as hereinunder:

- Expected option premium: Rs.30,000
- Transaction tax on exercise of option (@ 0.125%): Rs.3,750
- CTT on the seller of the underlying future: Rs.300
- Total tax on transaction: Rs.4,050 which is 13.5% of the premium

Unlike the securities market, where many option buyers square up positions, a desirable feature of the commodity markets is that the farmers and manufacturer are incentivised to deliver their goods. However, such a high tax incidence would defeat the very purpose of introducing options trading. Without volumes, transaction tax on exercise of option is unlikely to yield even the desired revenues. Thus there is little economic rationale for imposition of a transaction tax on options trading

Demonetisation has set the stage for curbing dabba trading. Removal of CTT would accelerate this process by shifting such transactions to the formal sector. The loss of revenue on this account would be miniscule. During this financial year, CTT was expected to yield about Rs.600 crore — a small sacrifice for removal of the main factor constraining the development of the commodity markets. A resultant spurt in turnover and allied activities will create jobs — the most pressing problem facing the country. It will also enable small and medium enterprises to hedge risks on domestic exchanges — a far cheaper option compared to hedging on international exchanges.

The balance of convenience clearly lies in repealing CTT on non-agricultural commodities and non-imposition of transaction taxes on the proposed options trading. This will enable the commodity markets to fulfill their primary mandate of price discovery and risk management for two of the most vulnerable sectors of the economy viz. agriculture and small and medium sector enterprises.

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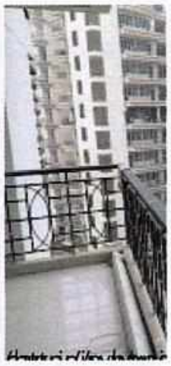

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