◆ **BRIEFING PAPER** ◆

Tax Financial Speculation

The Case for a Securities Transaction Tax in India

Kavaljit Singh

ASIA-EUROPE DIALOGUE PROJECT

PUBLIC INTEREST RESEARCH CENTRE

TAX FINANCIAL SPECULATION

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1 US Dollar = Rs 45 (2001)

Million is 1000000.

Billion is 1000 million.

Dollars are US dollars unless otherwise specified.

In commemoration of Dr Arun Ghosh

INDIAN financial markets are among the most speculative in the world. Compared with several leading international financial markets, the sheer volume of speculative trading in Indian financial markets is extremely high. Recent media reports have pointed out that Indian financial markets are second only to NASDAQ[1] in speculation, thereby surpassing the New York Stock Exchange (NYSE), the largest financial market in the world in terms of market capitalization.[2] Some of the leading financial markets such as London Stock Exchange (LSE), and markets in Germany, France, Hong Kong, Singapore and Japan have registered much lower degree of speculation.

The Magnitude of Financial Speculation

The speculative nature of financial markets could be grasped by the ratio of trading volume to total market capitalization. Table 1 provides monthly average turnover and market capitalization of leading financial markets of the world. The monthly turnover/market capitalization ratio of NASDAQ aggregated 33.4 per cent between January and December 2000. While the monthly turnover/market capitalization ratio of the four major financial markets in India was 28.8 per cent during this period. Surprisingly, the financial markets of Taiwan were next to India in terms of speculation.

The monthly turnover/market capitalization ratio of Indian financial markets was almost double than most of the developed and emerging markets. The ratio was approximately 14 per cent on LSE; 12 per cent in Deutsche Borse; 8 per cent on NYSE; and around 5 per cent in the financial markets of Hong Kong, Singapore, Australia and Tokyo. Among the emerging markets, Mexico's monthly

Table 1: Speculative Markets in the World

Exchange	Monthly average in 2000 Turnover	Market Capitalization	Turnover/mkt cap ratio (in %)
NASDAQ	1649900	59845906	33.39
India (Rs million)	2251670	7965080	28.81
Taiwan	82189	4360223	21.66
London	379889	32176086	14.14
Deutsche Borse	176677	16640942	12.64
NYSE	921671	134764673	8.22
Euronext Paris	88739	17647535	6.05
Hong Kong	31389	7350790	5.11
Tokyo	192958	46604834	4.90
Singapore	7929	1946834	4.88
Australia	18874	4653303	4.85
Thailand	1760	448824	4.55
Johannesburg	6454	2594431	2.98
Kuala Lumpur	4406	1750951	2.80
Mexico	3814	1701427	2.67

All figures (except India) are in US$ million.
Source: *Business Standard*, April 5, 2001.

turnover/market capitalization ratio was the lowest, pegged at 2.6 per cent, while the ratio stood at 2.8 per cent in Malaysia; and 2.9 per cent in South Africa.[3]

High Turnover: Boon or Bane?

The daily turnover in the Indian financial markets has increased manifold. Since the mid-1990s, there has been a sharp increase in

Table 2: Turnover and Delivery Pattern *(April-December, 2000)*

Item	BSE	NSE
(a) Total Turnover	7385840	11085700
(b) Total Delivery	974370	703880
% of (b) to (a)	13.19	6.35

Amount in Rs million.
Source: Securities and Exchange Board of India.

the daily turnover from about Rs 5500 million to Rs 150000 million currently. Compared to a mere Rs 1690 billion on March 31, 1995, the total turnover reported by all the 23 stock exchanges in the country touched a phenomenal Rs 33133 billion on March 31, 2001. However, a closer look at these figures reveals the inherent weaknesses of the Indian financial markets because actual deliveries are only a small portion of the turnover. For instance, during April-December 2000 period, a mere 13 per cent of trades was settled by actual delivery in the Bombay Stock Exchange (BSE) and as low as 6.3 per cent in the National Stock Exchange (NSE). The rest was purely speculative trading (see Table 2).

Much of the trading is concentrated in a handful of stocks. The top 10 stocks account for over 80 per cent of the turnover of the Indian financial markets. The top 100 stocks account for almost 99 per cent of the turnover. The floating stocks of top companies are also fewer. As a result, investors are collectively chasing a limited number of stocks. While there are several thousand stocks listed in the markets that are not traded at all. On March 31, 2001, there were 9985 stocks listed on all the 23 stock exchanges of India. These

facts starkly reveal the sordid state of affairs in the Indian markets.

Despite high volume of secondary market trading, financial markets are no longer performing the function of capital raising. New capital raised through primary markets has witnessed sharp decline over the years. Compared to Rs 228740 million raised in the year 1995-96, only Rs 78170 million was raised in 1999-2000. Paradoxically, in spite of the spurt in the overall numbers of new issues (particularly in the infotech sector) in the year 2000, the total amount of capital raised has declined. In the first nine months of the fiscal 2000-01, resource mobilization through public and rights issues was only Rs 42400 million. In the aftermath of Ketan Parekh stock scam of 2001, the primary markets have witnessed an all-time low in terms of capital mobilization. According to Prime Database (India's leading primary market database), only one public issue worth a mere Rs 18 million hit the Indian markets during April-July 2001.

As rightly pointed out by L C Gupta, Director of Society for Capital Market Research and Development (SCMRD), the high volume of speculative trading has not helped even an iota towards strengthening the market's capital raising function, rather it had the opposite effect.[4] Speculative trading in the financial markets diverts large amounts of financial resources away from productive purposes. As a result, fewer financial resources are available for funding long-term economic development programs. In addition, excessive speculation results in irrational price behavior and higher volatility in the financial markets.

Excessive Volatility: Cause for Concern

Over the years, the Indian financial markets have been showing excessive volatility. Volatility is the degree to which the price of an asset or the value of a portfolio fluctuates over time. It is usually measured statistically by standard deviation or variance. The higher the standard deviation, the more volatile is the asset. The greater the degree of variance, the greater the risk. Undeniably, volatility is a pervasive phenomenon in financial markets and no facet of finance has remained untouched by it. One cannot deny the fact that all financial markets are afflicted with some degree of volatility. But excessive volatility is a matter of serious concern because it induces fragility in the entire financial system. Besides, excessive volatility negatively affects investors' confidence.

The price volatility at the individual stock level is drastically high in the Indian markets. One can comprehend the actual volatility of individual share prices in India from the 52-week High and Low prices of the leading Indian stocks. The ratio between such High and Low prices in most cases exceeded 2:1 and in several cases it even jumped to 3:1.[5] Put simply, it means that prices of the leading shares swelled to more than double or fell to less than half within any 52-week period.

The Securities and Exchange Board of India (SEBI) carried out a study of the equity market volatility in 13 developed and emerging markets including India for the period 1990-99.[6] Extracted from the SEBI study, Table 3 reveals the stock index volatility of the markets in the US, the UK, Germany, Australia, Singapore, Thailand, Indonesia, Malaysia, Chile and India during 1990-99. The SEBI

Table 3: Stock Index Volatility *(Standard Deviation Percentage)*

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
US	1.00	0.90	0.61	0.55	0.62	0.49	0.74	1.14	1.28	1.16
UK	1.16	1.16	1.23	0.92	0.79	0.74	0.67	0.92	1.32	1.02
Germany	1.70	1.61	1.10	1.06	1.20	1.04	0.77	1.40	1.79	1.47
Australia	1.04	0.98	0.88	1.02	1.00	0.89	0.90	1.16	1.36	0.93
Singapore	1.46	1.06	0.89	1.08	1.14	0.82	0.81	2.49	2.33	1.32
Thailand	2.68	1.72	1.64	1.67	1.40	1.14	1.47	3.78	3.06	2.09
Indonesia	N A	N A	0.82	1.04	1.01	0.93	1.05	3.23	5.99	3.75
Malaysia	1.53	1.20	0.76	1.61	1.45	1.08	0.77	4.11	3.90	1.68
Chile	N A	N A	1.21	0.75	1.01	1.25	0.60	0.71	1.20	0.98
India	2.51	2.25	3.47	2.14	1.47	1.33	1.59	1.68	1.99	1.85

N A – Not Available

Indices: US - S&P 500; UK - FTSE 100; Germany - DAX 30 Xetra; Australia - All Ordinaries; Singapore - Straits Times; Thailand - Stock Exchange of Thailand; Indonesia - Jakarta Composite; Chile - Chile Stock Market General; Malaysia - Kuala Lumpur Composite; India - BSE Sensex.

Source: Extracted from Pratip Kar, M T Raju, Prabhakar R Patil and Kiran Karande, "Stock Market Volatility: A Comparative Study of Selected Markets," *Working Paper Series No. 2,* SEBI, January 2000, pp. 12-13.

study found that the average stock index volatility of Indian markets remained quite high (2.02 per cent) during this period. It was significantly higher than the developed markets – the US, the UK, Germany and Australia. Even in comparison to other emerging markets in Asia, India's stock index volatility has remained relatively higher except in the late 1990s when the Southeast Asian currency crisis occurred in 1997 which seriously engulfed the financial markets of the region. As a fallout of the currency crisis, stock index volatility in Malaysia increased almost five times, from 0.77 per cent in 1996 to 4.11 per cent in 1997. Other countries in the region, particularly Thailand, Malaysia, Singapore and Indonesia also experienced sharp rise in volatility. Remarkably, Chilean markets remained the least volatile (0.96 per cent) during 1992-99. This could be largely attributed to measures adopted by the Chilean authorities to regulate 'hot money' flows into the country in the 1990s.

According to the SEBI study, Indian markets exhibited the highest volatility of 3.47 per cent in 1992 when Harshad Mehta securities scam came to light. This study also found that the open-open volatility (2.01 per cent) has been the highest in the Indian markets followed by close-close volatility (1.91 per cent), day's high-low volatility (1.23 per cent) and day's open-close volatility (1.12 per cent) during the period 1991-99. The main reason behind this inter-day volatility (open-open or close-close) was the result of varying settlement periods adopted by different stock exchanges in India.

However, the intra-day volatility (measured as the difference between high and low during a day) of Sensex (the Sensitive Index of Bombay Stock Exchange) has also registered a steep increase since

Table 4: Intra-day Volatility in BSE Sensex

Year	Less than 100 points	100-200 points	200-300 points	Over 300 points	Trading Days
1994-95	304	1	-	-	305
1995-96	291	5	-	-	296
1996-97	256	37	3	1	297
1997-98	269	25	-	-	294
1998-99	201	39	2	-	242
1999-2000	139	84	23	8	254

Source: *Report on Currency and Finance 1999-2000,* Reserve Bank of India, 2001.

1998. During 1999-2000, the intra-day variations ranged between 200 to 300 points on 23 occasions and exceeded 300 points on 8 occasions (see Table 4). This level of intra-day volatility is quite high. The sharp increase could be largely attributed to developments in the international financial markets, particularly the tech-heavy NASDAQ.

A recent survey of investors conducted by SCMRD also found that 86 per cent of the respondents were of the view that Indian financial markets are speculation oriented rather than investment oriented and about 62 per cent felt that the markets are "excessively volatile." The survey also discovered that 83 per cent of responding managements cutting across all size and age group of companies agreed that the Indian equity markets are frequently manipulated despite regulations of the SEBI.

Since excessive volatility in the financial markets can adversely

affect savings, investments, interest rates and exchange rates, it poses imminent danger not only to the financial system but also to the real economy. Therefore, it is high time that financial stability should also be treated as public good.

Why Excessive Speculation and Volatility?

The moot question before us is: Why are Indian financial markets so speculative and volatile? In terms of volatility in the financial markets, there is an interesting debate on the causative reasons fuelling volatility. One dominant school of thought believes in the Efficient Market Hypothesis (EMH) which holds that changes in information affect stock prices. The proponents of this school argue that market movements can be explained entirely by the information that is provided to the market. One can understand the sharp rise in volatility during panic situations, particularly when the financial scams were rocking the Indian markets *a la* Harshad Mehta scam in 1992 and Ketan Parekh scam in March 2001.

Similarly, one can also comprehend sudden rise in volatility due to any major developments within the companies or macro economic fundamentals. However, sharp movements in the Indian financial markets, particularly in the past couple of years, cannot be explained entirely by these factors. These factors fail to explain why Indian markets have remained extremely volatile even during stable periods.

This brings us closer to the other school of thought which believes that market movements have nothing to do with economic or external factors. This school proposes that excessive volatility is

the result of investor reaction, largely due to psychological beliefs, and it deems 'noise traders' and speculators responsible for it.

Instead of getting embroiled in this debate on the reasons behind excessive volatility, let me focus on the systemic issues (for instance, weak regulatory and supervisory framework, belated corrective measures and growing integration with international markets) which have largely contributed towards excessive volatility and speculation in the Indian financial markets.

Weak Regulatory and Surveillance System

Weak regulatory and surveillance system is one of the major factors responsible for excessive volatility and speculation in India. For instance, take the case of short selling[7] which facilitates rampant price volatility in the Indian markets. Short selling is an extremely high risk activity, and therefore, heavily regulated throughout the world. In the US, for instance, the Securities and Exchange Commission has laid down strict regulations (Rules 10 a-1) under which it may be allowed. Under these rules, short selling may only be allowed if the last transaction was made at a price higher than the previous one (known as Up-Tick rule) or the last price was the same as the previous price, and the last price change before that was an increase (known as Zero-Tick rule). Like the US, other countries have also laid down strict rules to regulate short selling. Whereas the SEBI has yet to evolve a long-term policy towards regulating short selling in the Indian markets.

Absence of uniform settlement cycle and rolling settlement system across stock exchanges has also abetted excessive speculative

activity in the Indian markets in the past. There are two premier stock exchanges in the country – the BSE and the NSE – but these exchanges followed different settlement cycles. Till July 2001, the BSE followed a Monday to Friday cycle while the NSE followed a Wednesday to Tuesday cycle. This encouraged speculators and arbitrageurs to shift positions from one exchange to another to benefit from arbitrage opportunities. For instance, traders used to shift their positions from NSE to the BSE before the close of Tuesday. The adoption of different settlement periods not only led to greater speculative trading in the Indian markets but it also contributed to higher inter-day volatility.

In addition, SEBI did not enforce rolling settlement system in the Indian financial markets. Internationally, rolling settlement system has been accepted as the best practice of settling trades in the financial markets. Rolling settlement means that the trade is settled in a specified number of days after the date of trade. This is usually expressed as T+ *the number of days*. For instance, T+5 means that if you enter into a transaction on Monday, you will have to make the payment or hand over the shares after 5 business days, i.e., next Monday. In some of the leading international stock exchanges including the NYSE and NASDAQ, T+3 system is followed. In fact, these US-based stock exchanges are planning to shift to T+1 system for quicker settlement of transactions.

There are several advantages with rolling settlement system. Firstly, rolling settlement in all exchanges leads to a common settlement cycle. This curbs the shifting of positions among different stock exchanges by speculators. As a result, short-term speculators are kept at a distance. Secondly, speculators cannot carry-forward

positions under the rolling settlement. All transactions that take place during a trading day are settled at the end of the day and not bunched together and netted out at the end of the trading week. Thus, there is little scope for manipulation as the buyers and sellers have to settle their trades every day. This not only improves market transparency but also curbs excessive speculation since only genuine investors are expected to take positions.

Several studies have noted that the shortening of settlement periods leads to less volatility, quicker payments and, on the whole, improved market stability. However, one may still witness higher intra-day speculation rather than inter-day or inter-week speculation under the rolling settlement regime.

Instead of rolling settlements, Indian financial markets followed a weekly system with a 7-day settlement cycle. Under this system, the settlement of trades was carried out on Account Period basis, where trades done in a trading cycle of 5 days were consolidated and netted and settlement of such netted trades took place on a single day. With the help of *badla*[8] (discussed below in detail), speculators and traders were able to carry forward their positions without taking possession. This system provided ample opportunities to speculators to make a killing as they were given a 5-day free period between placing orders and deciding whether to settle, or give/take delivery or to opt for carry-forward or switch to another exchange. This system was largely responsible for low deliveries in the Indian financial markets. Besides, payments often used to take up to 12 days under this system.

However, in the aftermath of Ketan Parekh stock scam in early

2001, SEBI announced several policy measures including introduction of rolling settlement and uniform settlement cycle in the Indian markets. From July 2, 2001 onwards, SEBI has introduced T+5 rolling settlement in 414 stocks and by January 2002, all stocks are going to be traded only under rolling settlement system. It must be noted here that the proposal for rolling settlement and uniform settlement cycle across different exchanges was placed before SEBI some five years ago. One fails to understand why it took so long for SEBI to introduce these measures.

The prevalence of *badla* was also responsible for excessive speculation in the Indian markets. *Badla* served the purpose of 'noise traders' and speculators because it provided them easy credit to manipulate the market. Not only *badla* helped speculators to shift positions from one exchange to the other, it also diverted attention of the market players to a very limited number of stocks, and as a result, other stocks were rendered illiquid. The practice of *badla* was also misused by big companies, particularly those who have their own investment and finance subsidiaries. Through such subsidiaries, big companies used *badla* to prop up stocks of their parent companies. Thus, it will not be an overexaggeration to state that *badla* system was the progeny of speculators' club, who borrowed and lent among themselves, to manipulate the stock prices. It has been estimated that the total amount available under the *badla* markets (both official and unofficial) was to the tune of Rs 80000 million. Despite being in the know of flourishing unofficial *badla* markets in Calcutta and other cities, SEBI turned a blind eye to such illegal practices.

Badla had a chequered history in the Indian financial markets.

In late 1993, *Badla* was banned when SEBI realized that excessive speculation was the cause behind the securities scam of 1992. Regrettably, SEBI reintroduced it in 1996 under pressure from the powerful lobby of big financiers, merchant bankers and brokers. What was really disquieting is the fact that SEBI reintroduced *badla* without enforcing any of the safeguards recommended by its own Committee. However, it is quite interesting to note the developments in the Indian markets after the ban on *badla*. Despite being banned for two years – 1994 and 1995 – heavens did not fall on Indian markets. On the contrary, there were several positive outcomes. For instance, there was a considerable decline in volatility. As evident from SEBI's own study, the market volatility declined to 1.47 in 1994 and 1.33 in 1995 from the earlier range of 2.14-3.47 during the period 1990-93.[9] While the Sensex and investments by FIIs remained bullish during the ban period.

More importantly, there was a qualitative change in the trading pattern after the ban on *badla*. Undeniably, trading volumes in 'specified' stocks fell but the volume of trading in 'non-specified' stocks actually picked up substantially. Before *badla* was banned, trading in 'specified' stocks was 83 per cent of the total trading but after the ban, trading in 'non-specified' stocks touched as high as 89 per cent of the total trading in December 1994. In other words, banning *badla* led to broadening of liquidity. However, with the revival of *badla* by SEBI [launched under diluted forms such as Automated Lending and Borrowing Mechanism (ALBM) in NSE and Borrowing and Lending of Securities Scheme (BLESS) in BSE], the trading pattern completely reversed. This had wider consequences not only for the financial markets but also for the real

economy. The real economic growth emanates from small and medium enterprises pertaining to the 'non-specified' category rather than big corporate giants belonging to the 'specified' list.

Since July 2001, *badla* is once again banned. Instead new derivative products such as index futures and stock options have been introduced in the Indian markets. Derivatives, popularly known as wild beasts of finance, are risky instruments as they are highly leveraged. Analyzing the recent international experiences, there is no reason to believe that Indian financial markets can remain immune from derivative scandals. Pressure is likely to be generated by the powerful lobby of speculators and brokers for introducing stock futures in the Indian markets. The recently formed national forum of brokers, Securities Industry Association of India, has already demanded the introduction of futures on individual stocks.

It is a well-known fact that price volatility in individual stocks is much higher than the index futures because it is much easier to manipulate an individual stock than an index. That is why futures on individual stocks have been banned throughout the world including the US. The regulatory authorities should resist such pressures and ensure that such risky speculative instruments are not introduced in the Indian financial markets. Otherwise, one may witness massive frauds occurring at regular intervals in the Indian financial markets.

Another factor responsible for speculation in the Indian markets is the prevalence of order-drive system. Under this system, both buyers and sellers of stocks operate through a broker. As brokers

are supposed to find a matching counterparty, their role becomes decisive thereby providing opportunities for price manipulations. On the other hand, quote-driven system is a better system in terms of market transparency and stability. Under this system, there are several firms called market makers. Large companies have several market makers who compete among themselves for business. The role of the market makers is to buy and sell securities under all market conditions. The market makers quote a buying price (called bid price) and a selling price (called offer price). Not only quote-driven system provides better protection to investors as it is less prone to price manipulations, it also ensures market stability.

Market Manipulations by Rogue Traders

In spite of the introduction of sophisticated investment instruments (such as derivatives) and online trading, financial markets in India are highly inefficient and are frequently manipulated by a handful of rogue traders. A nexus consisting of big institutional investor-businessman-banker-official is powerful enough to manipulate the financial markets to its advantage. In recent years, we have also witnessed excessive speculative trading by big market operators degenerating into market manipulation. There is an entire history of frauds in the financial markets starting from the securities scam of 1992. Since then, major financial frauds have occurred in India every year throughout the nineties.[10]

The recurring financial frauds reveal that Indian financial markets are prone to abuse, manipulation and excessive speculation despite the establishment of SEBI and other regulatory authorities. Sadly, the response of SEBI has been reactive rather than proactive.

In fact, SEBI has come into the picture when the damage has already been done. It cannot be denied that SEBI had imposed additional volatility margins and introduced several new measures such as Price Bands[11] to check excessive market volatility from time to time. But these measures (despite their efficacy) are no substitute for market surveillance and monitoring by SEBI.

It is common knowledge that there are not only bear cartels but also bull cartels playing their games in the Indian financial markets. Why SEBI has not taken any action against such cartels in the past? What about insider trading, which is so rampant in the Indian markets? What about circular trading (a group of brokers buy and sell shares to generate volumes in specific stocks basically to lure other investors) so prevalent in the Indian markets? Why didn't SEBI take early action to prevent the nexus of the brokers and directors running the stock exchanges? Why SEBI didn't take any action against funds invested in Indian financial markets by dubious Overseas Corporate Bodies (OCBs) operating through Mauritius and other tax heavens? These are some of the questions SEBI has conspicuously evaded so far.

Therefore, it would be a gross misjudgment to hold speculators, financiers and big operators solely responsible for manipulations in the Indian financial markets. After all, it is the basic duty of SEBI to see to it that such players do not manipulate and destabilize the markets. A better surveillance system can surely bring a greater degree of order in the Indian financial markets. It is not true that there are no effective mechanisms to enforce strict market surveillance. For instance, the SEBI could have used online automated surveillance system to detect abnormal price movements of stocks.

Known as stock-watch system, this system keeps track of transactions and detects any abnormal price movement of stocks arising out of manipulations. SEBI has singularly failed to evolve a long-term strategy towards market surveillance.

The Pitfalls of Global Integration

With the entry of foreign institutional investors (FIIs) in 1992, there has been a significant increase in volatility in the Indian financial markets. Attracted by short-term speculative gains, FIIs bring 'hot money' flows which are highly liquid, volatile and footloose. Such financial flows can leave the country as quickly as they come, thereby perpetuating a financial crisis of one sort or another. Because of rapid capital mobility, the world has witnessed a number of financial crises starting from the Peso crisis in Mexico in 1994.

The liberalized policy measures for attracting foreign investment by successive governments in the 1990s has primarily led to a surge in 'hot money' flows to India. Till date, the cumulative FII investment in the Indian markets is to the tune of Rs 526470 million. Except a handful of big financial institutions, such as Unit Trust of India (UTI), no Indian institutional investor can match the financial clout of the FIIs. In fact, the equity exposure of all mutual funds including UTI is not even half of the investments made by the FIIs. With huge amounts of financial resources at their disposal, the FIIs happen to be the real market movers in the Indian financial markets.[12]

However, investments by FIIs are quite sensitive to both domestic and international developments. For instance, events such

as Southeast Asian currency crisis of 1997, Pokhran nuclear tests in 1998 and recent cuts in US interest rates negatively impacted the investments by the FIIs in the Indian financial markets. Analysts have inferred that volatility in the Indian financial markets has increased substantially with the entry of FIIs. According to a cross-country study of emerging markets by the IMF, stock price volatility in India has increased since FIIs were permitted to invest in the Indian markets.[13] The study made a comparative analysis of the period between 1976-1992 and 1992-1994, when for the first time the FIIs were allowed to invest in the Indian financial markets.

Since the integration of Indian financial markets with their global counterparts, any negative development in the international scene can trigger shockwaves in the domestic markets. The developments in international financial markets, particularly NASDAQ, have significantly influenced the movements in the prices of stocks and indices in the Indian financial markets. Due to increasing global integration, the co-efficient of correlation between the Sensex and the NASDAQ Composite Index has been registering large increase in the late 1990s. The impact of global integration was particularly severe in 1999-2000 when the BSE Sensex almost mimicked the NASDAQ Composite Index.

Unlike other emerging markets in Asia and Latin America, Indian markets have been insulated to some degree from the negative developments in the international markets because of non-convertibility of rupee. India was amongst the few countries which were not badly engulfed by the contagion effects of the Southeast Asian financial crisis of 1997. The non-convertibility of rupee and slower

pace of financial liberalization were important reasons for this. However, instead of learning lessons from the several episodes of financial crisis in emerging markets in the 1990s and consequently adopting policy measures to avert similar crises, the Indian authorities are recklessly pursuing financial liberalization.

What is Securities Transaction Tax?

Due to enormous volume of purely speculative financial transactions taking place in the Indian equity markets, my proposal is to levy a Securities Transaction Tax (STT) of 0.25 per cent. Since equity markets are more volatile than debt markets, STT should only be restricted to equity markets. STT should be applied on all transactions related to equities in the secondary markets. While transactions in the primary markets such as issue of new stock or debt instruments would be exempted from this tax. STT would be different from the Financial Transaction Tax (FTT), currently administered in several countries in various forms, in the sense that financial transactions such as debt instruments, bank withdrawals, loans, cheque writing, fixed deposits, transactions in the money markets, etc., would not fall under its jurisdiction.

STT needs to be uniformly imposed in all the stock exchanges in the country, otherwise traders are likely to shift to those exchanges which do not administer the tax. Both the Indian and foreign traders would be required to pay a STT for transactions in equity markets. There are several methods of levying the STT. The tax could be levied on buyers alone (100 per cent) or sellers alone (100 per cent), or on both (buyers 50 per cent, sellers 50 per cent).

Given the fact that bulk of transactions in the Indian financial markets are speculative, this tax can curb arbitrage and other speculative activities that destabilize the financial system. It needs to be pointed out here that speculation taxes are not a new phenomenon. Historically, several countries have taxed transactions in the financial markets. Despite the global trend towards lowering or eliminating such taxes, many countries, particularly the developed ones, are retaining these taxes.

In the aftermath of various financial crises in the emerging markets in the 1990s, there has been a growing interest in academic and policy circles on the feasibility of such a tax on domestic and international financial transactions. The earliest proponent of such a tax was John Maynard Keynes, who stressed that investment in real economy and trade, not speculation, should be the basis for financial transactions. Keynes stated, "It is usually agreed that casinos should, in the public interest, be inaccessible and expensive. And perhaps the same is true of Stock Exchanges."[14] In recent years, many leading mainstream economists including James Tobin, Joseph Stiglitz, Barry Eichengreen and Lawrence Summers have also endorsed the idea of a securities transaction tax.[15]

Six Arguments for Throwing Sand in the Wheels of Indian Financial Markets

There are several legitimate grounds for the adoption of a STT in the Indian financial markets.

First, the underlying logic of securities transaction tax is to slow down the flow of speculative money, as it would be taxed each time

a transaction takes place. STT is expected to curb purely short-term speculation by big operators, FIIs and fund managers without significantly affecting the long-term investors. The tax on equities held for a long period would be marginal while the tax on short-term purchases and sales would be higher.

A significant impact of the tax will be to reduce the volume of purely short-term financial transactions. Nowadays, traders usually hold assets for a few hours, or for that matter, even a few minutes. They earn a small profit on each transaction. A STT would be a strong deterrent for speculators trying to make quick profit on a huge sum by buying a financial instrument and selling it the next moment.

Short-term trading is one of the major factors responsible for increased market volatility. By raising the cost of speculative trading, a STT would go a long way towards restraining short-term trading, thereby making Indian financial markets less volatile and more efficient. Consequently, herd behavior and other factors that make financial markets more volatile and inefficient could be adequately checked.

On the whole, the financial markets are expected to be more stable once the tax is imposed. In the present times, stability in financial markets is of utmost concern as the Indian policy makers are determined to invest pension funds in the financial markets. In volatile markets, the deployment of pension funds, the only social safety net for a large number of people, may turn out to be an extremely risky proposition.

Second, the revenue potential of a 0.25 per cent of STT provides another rationale for its adoption. On an average, the daily trading in the Indian stock markets is to the tune of Rs 150000 million. By imposing a 0.25 per cent STT on this volume, tax authorities in India can collect Rs 375 million every day. As Indian financial markets operate on an average 250 days a year, a STT could generate revenue of Rs 93750 million every year. This is a substantial amount in the present times when the forces of globalization are constricting the country's ability to raise revenues through taxation.

The revenue potential of a STT cannot be brushed away given the fact that India's tax-GDP ratio is among the lowest in the world. India's tax-GDP ratio has fallen particularly in the 1990s – the decade of economic liberalization and globalization. The tax-GDP ratio in the year 2000-2001 was less than what it was in the early 1990s. The tax-GDP ratio has slided from 10.16 per cent in 1990-91 to 8.8 per cent in 1999-2000. The declining tax-GDP ratio is a matter of serious concern, and therefore, the authorities should examine avenues for imposing new taxes such as STT to raise additional revenue.

There is an urgent need to tax the financial economy that has remained virtually untaxed despite tremendous growth in the recent years. To a large extent, this has happened due to several loopholes in the present tax system, which have been consistently exploited by the big operators in the financial markets. For instance, the FIIs avoid paying taxes in India by routing their investments through countries (e.g., Mauritius) which have signed double tax avoidance treaties with India. Under this treaty, Mauritian residents and corporations who invest in India are taxed under the

Mauritian law rather than Indian law. Since Mauritius does not tax capital gains and dividend, it is no surprise that bulk of portfolio investment as well as foreign direct investment in India is routed through Mauritius.

But once we have a STT in India, the FIIs and other global fund managers would also come under its jurisdiction. Therefore, massive evasion of taxes could be effectively curbed by the imposition of a STT.

Revenue raised through STT could be utilized in several ways. Given the fact that Indian authorities are preoccupied with reduction in the fiscal deficit, this tax revenue could bridge the yawning fiscal gap. Alternatively, a part of these financial resources can be deployed to support specific developmental and anti-poverty programs in the country. Besides, a part of tax proceeds could also be canalized for creating a reserve that could be used when there is a liquidity crisis in the markets. While a part of the amount could be utilized by SEBI to further strengthen its capacity in terms of regulation and market surveillance.

Third, an additional advantage of a STT is that it could discourage 'hot money' flows, which are known for their volatile and destabilizing behavior. As recent international experience shows, developing countries are more vulnerable to 'hot money' flows, a STT could be an enabling mechanism to ensure some degree of insulation for the Indian financial markets from the deleterious effects of volatile financial flows.

Fourth, by cutting back financial resources in unproductive

speculation, a STT could encourage long-term financial flows. In the volatile financial markets, cost of capital increases because of risk factor. As a result, companies find it difficult to raise capital for long-term investment. Thus, in the long run, a STT has the potential to immensely benefit the real economy.

Fifth, a STT would be much easier to implement. Unlike Tobin tax[16], STT does not require international agreement or consensus to levy it. India, like any other country, is free to levy a STT. However, the imposition of a STT is not an easy task. The idea of a STT is likely to be resisted by the powerful lobby of speculators, financiers and fund managers as their speculative profits will be adversely affected. In 1992, SEBI had imposed a registration fee and an annual turnover fee of 0.01 per cent on brokers. The brokers challenged both the measures and took SEBI to court in 1993. In a significant judgement, the Supreme Court of India averred that the imposition of fees is legally tenable and dismissed the petition filed by the brokers' community.

The criticism of the tax by such an unholy alliance is likely to be centered on the question of its practicability and technical feasibility. It needs to be emphasized here that the obstacles to put restrictions on speculative trading in equity markets are not technical, but political. If the modern electronic system can enable sale and purchase of equities and collection of margins, why can not the same system be used to collect the STT?

Apprehensions voiced by the opponents of STT that it would drive out big financial transactions from Indian financial markets

may not prove true for three basic reasons. Firstly, the cost of a 0.25 per cent STT for long-term investments will be almost negligible. Secondly, there is no question of domestic funds leaving the country and migrating to other financial markets because of existing controls and regulations on the capital movements. Lastly, as far as foreign investors are concerned, a modest increase in the cost of financial transactions due to imposition of a STT would not lead genuine foreign traders to flee Indian markets. However, super profits of fly-by-night operators and 'noise traders' would be seriously hampered by a STT and they are likely to be driven out of the business.

Another likely criticism of a STT could be related to evasion. No doubt, all taxes (e.g., income tax, wealth tax, property tax, etc.) are open to evasion but this is not sound enough reason for not having them. Concerted efforts have to be made by the tax authorities to check loopholes and fine-tune the system, as no tax system in the world is foolproof.

Sixth, one of the main benefits of a STT lies in its progressive outlook as it penalizes speculation. The wider economic and developmental gains of taxing speculative money are more than the private gains of a handful of speculators, financiers and traders. If gambling in a casino or a state lottery ticket is considered an unethical act and therefore heavily taxed, why not impose a modest tax on speculation? Gambling in the financial markets is as pernicious as gambling in a casino.

As the major players in the financial markets are big speculators, financiers, fund managers, traders and wealthy individuals,

whose number in any case is minuscule, a STT would only affect their businesses without having a direct bearing on majority of Indian people. Rather, the STT would provide some protection to small investors who often end up as the real losers in the volatile financial markets.

International Experiences with Securities Transaction Taxes

Taxes on securities transactions are not new. Not long ago, taxes on securities transactions have been imposed in several countries including the US, Japan, France and the UK. Several countries are still retaining different types of securities transaction taxes.

Table 5 provides the list of countries that have imposed transaction taxes of various kinds. Some countries have imposed tax on stock trading while many others have taxed a variety of financial transactions.

The US imposed a financial transaction tax (FTT) from 1914 to 1966. During this period, the US had a federal tax on stock sales of 0.1 per cent at issuance and 0.04 per cent on transfers. Currently, the US has a 0.0034 per cent tax which is levied on stock transactions. The tax, known as Section 31 fee, is used to support the operation costs of the Securities and Exchange Commission (SEC). In 1998, the federal government collected $1.8 billion as revenue from these fees in 1998, almost five times the annual operating costs of the SEC.

UK has a financial transaction tax in the form of stamp duty, which is not levied on transactions *per se* but on the registration of

Table 5: Securities Transaction Taxes around the World

Country	Tax Size	Description	Changes since 1991
Australia	0.3%	Transaction tax	Additional stamp tax removed in 1991
Austria	0.15%	Transfer tax	May be avoided by trading off exchange
	0.06%	Arrangement fee	May be avoided by trading off exchange
	0.04%-0.09%	Courtage fee	
Belgium	0.17%	Stamp tax on purchases and sales	No tax ex country; maximum of 10000 Belgian francs
	0.025%	Stock market fee	No tax ex country; maximum of 2500 Belgian francs
Finland	0.5%	Transaction fee	Waived if parties foreign; eliminated in 1992
France	0.15%	Trading tax	Tax on trades exceeding 1 million francs. Rate is doubled on smaller transactions. May be avoided by trading ex country
Germany	0.125%	Boersenumsatzsteuer	Residents only
	0.06%	Courtage tax (official border fee)	May be avoided by trading ex country
Hong Kong	0.25%	Stamp duty	
	0.006%	Special levy	May be avoided by trading off market
	0.05%	Exchange levy	May be avoided by trading off market
Italy	0.14%	Stamp duty tax	May be avoided by trading ex country

contd. on next page

Japan	0.3%	Sales tax	May be avoided by trading ex country; eliminated in 1999
Malaysia	0.05% 0.3%	Clearing fee Transfer stamp duty on purchases and sales	Maximum $100; may by avoided by trading off exchange Eliminated in 1992
New Zealand	0.0057% plus per trade fee	Transaction levy	May be avoided by trading off exchange; eliminated in 1992
Singapore	0.1% 0.05% 0.2%	Contract stamp duty Clearing fee Transfer stamp duty	May be avoided by trading off exchange Maximum $100; may be avoided by trading off exchnage Purchase only; eliminated in 1992
Sweden	0.5%	Turnover tax	May be avoided by trading ex country; eliminated in 1991
Switzerland	0.15% 0.3% 0.0001%	Exchange fee State tax Turnover tax	On domestic securities On foreign securities Several financial intermediaries have been exempted
U S	0.0034%	SEC fee	
U K	0.5% 0.5%	Stamp duty reserve tax Stamp duty tax	On purchases only On purchases only

Source: Jeffrey Frankel, "How Well Do Foreign Exchange Markets Work: Might a Tobin Tax Help?," in Mahbub ul Haq, Inge Kaul and Isabelle Grunberg (eds.), *The Tobin Tax: Coping with Financial Volatility*, Oxford University Press, New York, p. 70, 1996. Updated by author from other sources including Karl Habermeier and Andrei Kirilenko, "Securities Transaction Taxes and Financial Markets," *IMF Working Paper*, WP/01/51, IMF, May 2001.

securities. The stamp duty has been in existence for many decades, but in recent years, it has been reduced. Presently, UK levies a 0.5 per cent stamp duty and stamp duty reserve tax on equity and other financial transactions. Stamp duty is charged if the transfer is effected via a transfer form and stamp duty reserve tax is charged if the transfer is routed through CREST, the settlement system of UK securities industry. No one can claim legal ownership of stock without the stamp. Transactions in UK registered shares carried outside the country are liable to stamp duty only when the document enters the UK. There are no territorial restrictions on the stamp duty reserve tax. Buyers pay the stamp duty and stamp duty reserve tax. During 1998-99, the authorities collected 2.1 billion pounds from securities transactions.

Belgium is another European country which has levied a 0.17 per cent transaction tax on stocks and a 0.07 per cent tax on bonds. Transactions in other financial instruments are also taxed, with varying rates. Both buyers and sellers are subject to the tax, but the tax base is calculated differentially. Further, there is a ceiling of 10000 Belgian francs on the joint amount payable. However, certain financial intermediaries have been exempted from the tax.

France has a transaction tax on equity trading. The tax rate depends on the amount of transaction. The country levies a 0.15 per cent transaction tax on equity trades exceeding 1 million francs. For transactions below 1 million francs the rate is higher, at 0.3 per cent. There is a ceiling of 5000 francs on the total tax amount. The tax is payable by both sellers and buyers. Certain shares and financial intermediaries have been exempted from this tax.

Till 1999, Japan had also imposed a financial transaction tax. The tax was imposed on a variety of financial instruments. It was levied on both debt and equity instruments but at differential rates. The tax rates were higher on equities than on debentures and bonds. Implementation of a FTT in Japan was quite successful as it helped the government to raised substantial revenue. As late as the 1980s, the Japanese government was generating revenues of about $12 billion per year. This is not an insignificant amount. However, as part of 'big bang' liberalization of the financial sector, Japan withdrew this tax in 1999.

Italy has a transaction tax in the form of stamp duty. The country levies a 0.14 per cent stamp duty on domestic off-exchange transactions. Likewise, Switzerland also has a stamp duty on financial transactions. Switzerland levies a 0.15 per cent tax for transactions in Swiss securities and 0.3 per cent on transactions in foreign securities. Besides stamp duty, the country also levies a share turnover fee of 0.0001 per cent. In recent months, the Swiss authorities have exempted several financial intermediaries from the fee.

Sweden and Finland had introduced a transaction tax on a host of financial instruments in the mid-1980s. However, financial literature suggests that the introduction of transaction tax was a complete failure in Sweden and Finland. In case of Sweden, not only the revenues dropped but the FTT also contributed towards migration of stock trading from Stockholm to other financial centers.

Among the emerging markets, Malaysia, Singapore, New Zealand and Hong Kong have imposed transaction taxes on a variety of financial instruments. In India too, stamp duty on securities

has been in existence for several decades. It is payable by the buyer at the rate of 0.5 per cent for the registration of share certificates calculated on the basis of contract value. The rate of stamp duty varies from state to state. Imposition of stamp duty has been mired by controversy. The Stamp Office, which collects the duty, insists that the stamp duty is applicable on securities transactions as well. Whereas the brokers argue that the duty is only on registration of ownership.

On the whole, there is vast international experience with transaction taxes which could help Indian policy makers to evolve a long-term strategy towards imposing a STT in the financial markets.

Concluding Remarks

While advocating the case for a STT, I am not arguing that all problems related to volatile and speculative behavior of Indian equity markets would be resolved by this measure. In the present times, no single mechanism by itself can solve all problems plaguing the Indian financial markets. I am also not arguing that a STT is a substitute to market regulation and surveillance. However, if used in conjunction with other policy mechanisms (e.g., quote-driven system, regulation of short selling and insider trading, etc.), STT offers a potent mechanism to address multiple issues related to speculation, volatility and manipulations in Indian financial markets. Therefore, the idea of a STT requires closer scrutiny by the regulatory authorities and policy makers.

Notes and References

1. National Association of Securities Dealers Automated Quotation System (NASDAQ) is an US-based financial market. It is owned and operated by the National Association of Securities Dealers. Majority of companies listed on NASDAQ belong to the infotech sector. Companies listed on NASDAQ are generally small and new. But some of the listed companies (like Microsoft and Intel) have become huge entities in terms of market capitalization. NASDAQ screens are available worldwide.

2. See, for instance, B G Shirsat, "Indian Bourses Second-most Speculative after Nasdaq," *Business Standard,* April 5, 2001; and Rishi Chopra, "Excessive Speculation Plagues Capital Markets," *The Economic Times,* May 8, 2001.

3. B G Shirsat, op. cit.

4. L C Gupta, "Regulatory Confusion," *The Economic Times,* November 1, 2000.

5. L C Gupta, "Policy Lessons from the Recent Stock Market Crisis," *The Economic Times*, April 5, 2001.

6. Pratip Kar, M T Raju, Prabhakar R Patil and Kiran Karande, "Stock Market Volatility: A Comparative Study of Selected Markets," *Working Paper Series No. 2*, SEBI, January 2000.

7. Short selling is the process of selling a stock without owning it on the expectation of being able to buy it back later at a lower price. The short seller expects prices to fall.

8. *Badla* is an old carry forward system used in Indian financial markets. Under this system, a buyer and seller have the option to carry forward their trades to the next settlement without delivering the stocks or making payments. *Badla* is the price payable by the buyer to carry over speculative purchases to the next settlement.

9. Pratip Kar (et.al), op. cit.

10. For a detailed analysis of financial frauds in the 1990s, see, Kavaljit Singh, "Financial Frauds and Market Crashes: Casino Capitalism Indian-style," *PIRC Briefing Paper,* PIRC, April 2001.

11. Price Bands, also known as circuit breakers or circuit filters, set the upper and lower limits within which a stock or index can fluctuate on any given day or during the trading cycle. Price Bands are designed to prevent extreme price movements of shares and indices. Regulators use these measures to reduce volatility. Price Bands were first used in October 1987 when stock prices collapsed in several developed markets. Experience shows that Price Bands are a deterrent against speculators wanting to quickly manipulate prices of stocks.

12. For details, see, Kavaljit Singh, "The Southeast Asian Currency Crisis and India: Impact and Implications," *PIRC Occasional Paper,* No. 5, PIRC, 1998; and Kavaljit Singh, *The Globalization of Finance: A Citizen's Guide*, Madhyam Books, DAGA, IPSR Books and Zed Books, 1999.

13. Aziz Jahangir, "Discretionary Trading and Asset Price Volatility," *IMF Working Paper,* No. 95/104, IMF, October 1995.

14. J M Keynes, *The General Theory of Employment, Interest and Money,* Harcourt Brace and World Inc., New York, p. 159, 1935.

15. See, for instance, James Tobin, "On the Efficiency of the Financial System," *Lloyds Bank Review*, 153, pp. 1-15, 1984; Joseph E Stiglitz, "Using Tax Policy to Curb Speculative Short-Term Trading," *Journal of Financial Services Research*, 3, pp. 101-15, 1989; Lawrence H Summers and Victgoria P Summers, "When Financial Markets Work Too Well: A Cautious Case For A Securities Transaction Tax," *Journal of Financial Services Research*, 3, pp. 261-86, 1989; Barry Eichengreen, James Tobin and Charles Wyplosz, "Two Cases for Sand in the Wheels of International Finance," *Economic Journal*, 105, pp. 162-72, 1995.

16. Professor James Tobin in his Janeway Lectures at Princeton first proposed a tax on global foreign exchange transactions in 1972, it came to be popularly known as Tobin tax. Realizing the need for "throw(ing) some sand in the wheels" of global financial markets, Tobin advocated the tax as a mechanism for discouraging speculation in short-term foreign exchange dealings. He proposed a 0.25 per cent tax on currency transactions in order to control volatility in the international currency markets and to preserve some autonomy in national monetary policies.

◆ BRIEFING PAPER ◆

Indian financial markets are among the most speculative and volatile in the world. To curb unproductive speculation and excessive volatility, the author proposes a Securities Transaction Tax (STT) of 0.25 per cent. The author argues that the wider economic and developmental gains of taxing speculative money in stock markets are more than the private gains of a handful of speculators, financiers and traders. If gambling in a casino or a state lottery ticket is considered an unethical act and therefore heavily taxed, why not impose a modest tax on speculation in Indian markets, asks the author. The paper provides legitimate grounds for imposing a STT on Indian financial markets. It underscores the point that the obstacles to put restrictions on speculative trading are not technical, but political. If several countries including the US, UK and Japan could impose taxes on securities transactions over time, what prevents India from imposing such taxes? The author calls upon policy makers to closely examine the proposal of a STT.

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Asia-Europe Dialogue Project is a collective effort to encourage and strengthen dialogue among various organizations for evolving alternative strategies of development. Initiated by Heinrich Böll Foundation, the project runs a website and works closely with like-minded individuals and organizations in Asia and Europe.

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