Why LTCG tax on stock market investments is a welcome move

Alevy of 10% tax on long term capital gains (LTCG) from equities, over and above gains of Rs1 lakh, has triggered a large correction and volatility in the Indian stock markets during the last two weeks. The sharp correction and high volatility was expected. The question then is: Why has India opted for the LTCG tax?

Amendment in Mauritius Treaty

To prevent the round-tripping of funds arising from the India Mauritius Tax Treaty, to mitigate the discriminatory tax treatment towards Indian investors, and to promote investment in stock markets, India abolished the LTCG tax on equities in 2004-05. This, however, did not resolve the round-tripping problem. Therefore, the Indian government amended the India Mauritius Tax Treaty in May 2016, reserving the right to tax capital gains on transfer of shares acquired on or after April 2017. With this amendment in place, there is now no need to exempt Indian investors from the LTCG tax.

Booming share market

Over the years, the Indian share market has gained width and depth. In 2017, it emerged as the eighth largest market in the world. Ideally, a part of this prosperity should go to the Indian government in the form of tax revenue.

Tax burden and fiscal considerations

According to "The Global Competitiveness Report, 2017-2018", the total tax rate as a percentage of profit was around 60% in India. Despite the heavy tax rates, India's budget balance as a percentage of GDP is much higher than that of the most competitive countries in the world.

This is not surprising if we look at the tax-to-GDP ratio. World development indicators published by the World Bank indicate that India's tax revenue as a percentage of GDP has been around 10.5% during the last 10 years, which is just marginally higher than that of the US' around 10%. Of the total revenue that India generates, around 55% comes from direct taxes, compared to 92% in the US. High tax-to-profit ratio, low tax revenue-to-GDP ratio, and the comparatively lower share of direct taxes in total tax revenue hint at inefficiencies and anomalies in the Indian tax structure.

Calibration of various direct tax rates is needed to reduce the tax-to-profit ratio, but at the same time it is required to moderate the fiscal imbalances and to improve the share of direct taxes in total tax revenue. High tax rates discourage economic activity, but zero tax rates result in zero revenue for the government. Mild (optimum) tax rates are needed to improve government revenue without dampening the impact on economic activity. A reduction in the corporate tax rate from 30% to 25% for companies with revenue of up to Rs250 crore and, at the same time, an increase in the LTCG tax on equities from zero to 10% on gains of more than Rs1 lakh, is a required calibration.

Equality considerations

Oxfam's "Global Inequality Report", released on 22 January 2018, indicates that inequality is rising in India. As per the report, the richest 1% of the population owned 58% of the wealth generated in 2016 and 73% in 2017. A comparatively larger share of indirect taxes, which are considered to be regressive in nature, further accentuates income inequality. An LTCG tax will help improve the share of direct taxes in total tax revenue and moderate the gap between the rich and the poor to some extent.

Market reactions, fundamentals and capital flows

We cannot attribute the entire fall in the Sensex and the volatility in the stock markets observed during the last two weeks to the LTCG tax proposal.

Last year, the Sensex recorded a 28% rise, which was much higher than its normal course. Market experts were warning the public that these gains could not be sustained for very long as they were not supported by the earnings. Even if the government had not announced the LTCG tax in this budget, the markets would have gone through the much-required correction. The LTCG tax simply triggered the long-pending correction.

With the tax, there is better parity in India's tax treatment of LTCG from equities with other countries and better integration of Indian markets with global ones.

The high volatility in the last two weeks is largely a manifestation of greater integration of Indian markets with global markets, which are witnessing high volatility due to fears of rising inflation and spikes in US treasury yields.

Now India also has better parity in taxes on LTCG from different sources. Therefore, once the required correction takes place, the fundamental strength of the economy, rather than tax sops, will drive the flow of funds from domestic as well as foreign participants in Indian markets.

Though the LTCG tax on equities is not as revolutionary as the goods and services tax, it can bridge an important gap in India's direct tax structure.

Let us hope that the country carries forward further rationalization of the taxes on capital gains from different types of assets.

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Comments are welcome at theirview@livemint.com

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