# Tax policy for an IFC in Mumbai

chapter 12

## 1. Does India need an IFC or a Tax Haven?

Creating an IFC in Mumbai – that offers IFS as competitively and efficiently as other established IFCs– will induce lobbying pressure on the authorities, from service providers as well as global investors, to provide zero or near-zero taxation of the IFS offered. Such pressures are based on three arguments: (a) the desirability of creating a tax haven explicitly in order to attract a greater proportion of global IFS flows for servicing through India; (b) the 'obvious' need for providing *temporary* fiscal subsidies aimed at kick-starting a desirable export services industry using *infant industry* arguments; or, more legitimately, (c) achieving greater competitiveness with other established and emergent/aspirant IFCs.

In that connection, proponents for total tax-exemption of an IFC to encourage IFS exports – or for exemption of at least some IFS products and services – often point to the success of the Indian IT export services industry since 1990. They argue that explosive growth in IT export services occurred at least in part because of (a) benign Government neglect, resulting in few opportunities for interference and petty rent seeking; and (b) initially favourable tax treatment – which, of course, the IT industry (along with others) is attempting to perpetuate through devices like SEZs.

In the view of the HPEC– which is in favour of global competitiveness – these pressures have no legitimacy in an effort to create an IFC in Mumbai. They should be resisted at municipal, state and central levels. A country like India does not need a tax haven. As has been argued before, India is not a small enclave or island economy, with limited options for economic diversification and growth.

Moreover, the current global climate (especially in OECD countries but also in countries like India) is opposed to 'tax competition' or, more euphemistically, 'harmful tax practices'.[1] In particular, the OECD disfavours 'dual tax regimes' offered by small countries to create tax-arbitrage to the detriment of its member countries. They object to a non-OECD country applying a 'normal' tax regime to its own citizens/residents, while offering non-residents a low-tax or no-tax-regime

[1] GoI should recognise, however, that this is a self-serving characterisation, contrived to permit governments of rich (but uncompetitive) OECD countries to maintain egregiously high tax regimes that support wasteful public expenditure. Such tax-spend policies enable too large an intermediation role to be played by these governments (particularly in Europe) in transferring – opaquely and unaccountably – real income from one part of the middle-class (e.g. the healthy, young working adults, or the childless) to another (families with children, those on the dole, those who smoke/drink excessively, retirees who have not saved enough) – in so-called 'public service' domains that are more efficiently served by private markets. Public revenues (and expenditures) in many north European countries now pre-empt over 50–60% of GDP. They finance unsustainable, failing public health, education and welfare systems. These nations are becoming uncompetitive and losing jobs – indeed entire industries – to poorer (therefore lower-cost, more competitive) countries like China (in manufacturing) and India (in services and manufacturing as well). Under domestic political pressure, OECD governments (particularly in Europe) are now engaging in a cartelised form of 'protectionism' to insulate themselves from competition by developing countries that have lower public revenues and expenditures of the region of 20% of GDP in order to encourage savings, investment, growth, markets and competitiveness. Yet the new accession countries to the EU have been introducing low flat tax regimes that are proving simpler, more attractive and more efficient. Poorer countries must eventually attain levels of per capita income and standards of living now enjoyed in the OECD world. In an efficient, equitable, open global economy, average per-capita incomes should converge gradually. If it takes tax competition to achieve that happy state, then that is how it should be. GoI should not accept the anti-tax-competition argument as having any intellectual legitimacy.

at the same time. But the OECD cannot oppose or punish (via sanctions or black-listing) an emirate like Dubai offering the same uniform 'low-tax' or 'no-tax' regime to residents and non-residents alike. Doing so would violate a key tenet of international law: *i.e.*, the sovereign right of countries to determine their own fiscal policies, as long as they do not create discriminatory dual regimes aimed solely at tax-arbitrage, or apply their tax policies in a way that affects adversely the fiscal rights of other countries. Besides, apart from issues created by artificial tax-arbitrage, an emirate in the Gulf may not need to levy any personal income or corporate taxes, because of a surplus of public income derived from sources such as oil/gas revenues or the sale of land, or whatever.

In such a climate, creating a tax haven would be detrimental for an IFC in Mumbai. Besides as an observer (and potential new member) of the Financial Action Task Force (FATF), the Indian government can hardly countenance the creation of yet another tax-haven OFC. Doing so would trivialise the two main arguments for having an IFC in the first place – *i.e.*, (i) to meet India's (and Asia's) legitimate and rapidly growing IFS needs as one of the world's largest emerging trading and investing economies; and (ii) to derive significant service export revenues from IFS, in which India has natural comparative/competitive advantages for capturing significant global market share. A tax haven would compromise the functioning and credibility of an Indian IFC in the eyes of the world. That is another reason why the Committee would advise against locating an IFC in Mumbai (or anywhere else in India) in a SEZ.

Also, experience suggests that *infant industry* arguments in India are dangerous. Prior to 1991, over-susceptibility to that argument resulted in India nurturing 50-year old infants in all its industries other than IT.

Many offshore financial centres in small landlocked and island countries chose to become tax havens – for multinational corporations as well as wealthy private individuals and trusts – to create a tax arbitrage advantage for themselves in attracting international financial business (*i.e.*, transfer pricing, tax management, and avoidance of high tax in OECD countries by their residents). There are over 65 such centres around the world (see Box 12.1) in landlocked principalities and micro-countries such as Andorra, Botswana, Monaco, Luxembourg, Lichtenstein, etc. as well as in island economies in: the north Atlantic vicinity (the Channel Islands, Bermuda, Isle of Man); in the Caribbean (where there are over fifteen OFCs, the largest being The Bahamas, The Cayman Islands, Barbados and the Netherlands Antilles); as well as in the Indian Ocean (Seychelles, and Mauritius) and Pacific (*e.g.*, Vanuatu).

OFCs derive revenues from the legal, tax and accounting services offered to firms that seek to tax-domicile, or book transactions, in these jurisdictions to avail of near-zero tax rates. In the relative context of their economies (e.g. Mauritius has a GDP of US$ 5.5 billion or less than the sales of the Reliance Group) such limited IFS revenues can be quite large (>5% of GNI). But such a strategy is inappropriate for India. An IFC in Mumbai should aim to achieve not just the booking of IFS transactions but the actual provision of the product/service underlying them. India's strength lies in its human and technological capacity to provide tradable financial services and capture the value added on a significant scale by world standards; not just to the small extent of routine legal, tax, audit or accounting services offered in a tax haven. As an IFC, Mumbai should therefore aspire to become like London or New York; a venue where large-scale IFS production and exports takes place for the global market rather than being content as a mere transactions-booking centre and artificial company registry.

Many financial transactions in a successful IFC, such as bond issues, securitisation products and derivatives contracts, involve embarking on a contractual structure with consequent cash-flows taking place as per contract for the coming 20 or even 50 years. In order to give the private sector confidence in undertaking such transactions, India needs to establish a sound tax framework

### Box 12.1: *Countries, Territories, and Jurisdictions with Offshore Financial Centres*

| Africa | Asia and Pacific | Europe | Middle East | Western Hemisphere |
|---|---|---|---|---|
| Djibouti | Cook Islands (FSF) | Andorra (FSF) | Bahrain (J) (OG) (FSF) | Anguilla (FSF) |
| Liberia (J) | Guam | Campione | Israel | Antigua (FSF) |
| Mauritius (OG) (FSF) | Hong Kong, SAR (J) (OG) (FSF) | Cyprus (OG) (FSF) | Lebanon (J) (OG) (FSF) | Aruba (J) (OG) (FSF) |
| Seychelles (FSF) | Japan[1] | Dublin, Ireland (FSF) | | Bahamas (J) (OG) (FSF) |
| Tangier | Labuan, Malaysia (FSF) | Gibraltar (OG) (FSF) | | Barbados (J) (OG) (FSF) |
| | Macao, SAR (FSF) | Guernsey (OG) (FSF) | | Belize (FSF) |
| | Marianas | Isle of Man (OG) (FSF) | | Bermuda (J) (OG) (FSF) |
| | Marshall Islands (FSF) | Jersey (OG) (FSF) | | British Virgin Islands (FSF) |
| | Micronesia | Liechtenstein (FSF) | | Cayman Islands (J) (OG) (FSF) |
| | Nauru (FSF) | London, UK | | Costa Rica (FSF) |
| | Niue (FSF) | Luxembourg (FSF) | | Dominica |
| | Philippines | Madeira | | Grenada |
| | Singapore[2](J) (OG) (FSF) | Malta (OG) (FSF) | | Montserrat |
| | Tahiti | Monaco (FSF) | | Netherlands Antilles (J) (OG) (FSF) |
| | Thailand[3] | Netherlands | | Panama (J) (OG) (FSF) |
| | Vanuatu (J) (OG) (FSF) | Switzerland (FSF) | | Puerto Rico |
| | Western Samoa (FSF) | | | St. Kitts and Nevis (FSF) |
| | | | | St. Lucia (FSF) |
| | | | | St. Vincent and Grenadines (FSF) |
| | | | | Turks and Caicos Islands (FSF) |
| | | | | United States[4] |
| | | | | Uruguay |
| | | | | West Indies (UK) (J)[5] |

Source: Based on Errico and Musalem (1999), IMF Working Paper WP/99/5 (unless otherwise indicated).

Legenda:
(J) = Joint BIS-IMF-OECD-World Bank Statistics on External Debt.
(OG) = Offshore Group of Banking Supervisors.
(FSF) = Financial Stability Forum's Working Group on Offshore Financial Centers (Press Release of May 26, 2000).
[1] Japanese Offshore Market (JOM).
[2] Asian Currency Units (ACUS).
[3] Bangkok International Banking Facilities (BIBFS).
[4] US International Banking Facilities (IBFS).
[5] Includes Virgin Islands, Anguilla, and Monserrat.

which will be sustained in the long term. An artificial 'infant industry' argument based on tax breaks is not credible in the eyes of the private sector, for it is clear that once the IFC takes hold, the tax code will be changed. This very uncertainty about future tax treatment will serve to deter transactions from taking place in Mumbai.

Through the proliferation of ICT technologies, it is now increasingly feasible to decouple the booking of an IFS transaction from where it is produced. Tax domiciles can be far removed from locations where real IFS value is added. To the extent that this takes place, India will not be *disadvantaged* by having a rational taxation regime governing its IFC. Global customers will still buy genuine IFS from India (providing those IFS are of the same quality, but provided at lower cost, with greater efficiency, and better customer service) even if they might prefer – for global tax management reasons – to book transactions in tax havens around the world.

There are deeper problems with an 'industrial policy' of government supporting the financial industry or IFS via tax incentives. If the government 'encourages' financial firms through lower tax rates, this would implicitly constitute a subsidy from the general taxpayer to shareholders and workers in financial firms. Such a fiscal subsidy for an IFC is neither necessary nor justifiable. More importantly, if financial firms in a Mumbai-based IFC were provided with a tax advantage over firms undertaking other types of activity, that would encourage less competitive firms (*i.e.*, smaller, weaker and insufficiently capitalised) to provide IFS. It would also provide an incentive for other types of services firms to camouflage themselves as financial firms. An ecosystem with financial firms propped up by tax incentives and exemptions is not one that would be populated by the most capable, efficient and innovative financial firms nor would it necessarily attract global financial firms to locate in such a IFC.

But, it should be emphasised that the argument against tax exemptions, or any form of preferential tax treatment in an IFC, is not the same as making an argument for having a regime of generally high, complex and harmful taxes – that provide disincentives for effort, transparency, volunteerism and honesty in tax payments – being applied to the IFC either. What would be best for an Indian IFC– as well as for the rest of industrial, commercial and financial India – is a general regime of uniformly low marginal tax rates, applied universally across the board in every sector of economic activity without any exception (including agriculture and agricultural finance) with as few tax incentives, exceptions and exemptions as possible.[2] The tax regime should be simple, and structured so as to be as non-discriminatory and non-distortionary as possible; *i.e.*, across different activities, and in the tax-treatment of income derived from different sources (*e.g.*, whether trading, dividends, interest, rent, wages, partnership profits, or salaries).

[2]In that connection it needs to be observed that inadequate prior analysis, and confused policy support (lacking full public consensus), has resulted in far too many disparate, variably-sized SEZs being approved by central and state governments, in too many fragmented locations. That has compromised the tax principle being enunciated here at the outset. It has also created opportunities for distortions to arise in piecemeal, imbalanced investment in infrastructure around the country. That reduces the prospect of economies of scale from being exploited; e.g. by fragmenting power generation across SEZs rather than having generation being determined by the needs of a particular contiguous area or geographic region. Moreover, it appears that many approved SEZs now incorporate sub-projects for speculative real estate development for residential and commercial purposes (as opposed to dedicated manufacturing or service industry use). These entirely unnecessary add-ons could compromise the financial portfolios of major financial firms lending to SEZs and to firms locating in them. That harm should not be exacerbated by extending similar tax benefits to an IFC.

## 2. Tax policy for Mumbai as an IFC: and, by implication, for India

By and large, the HPEC endorses fully, and urges swift implementation of all the recommendations contained in the Kelkar Committee Report (*i.e.*, *Report of the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act, 2003*) that was issued in June 2004. The kind of tax regime suggested by the Kelkar Report should be applicable to the financial system (domestic and IFC) as a whole – one that provides incentives for increased output, high value-addition, and efficiency rather than for tax breaks.

It would also be the desired strategy to apply to an IFC while keeping in mind the need for flexibility to make adjustments for certain types of IFS in keeping with international norms. Such flexibility would be desirable to ensure that an IFC in Mumbai remained competitive with IFCs elsewhere. With clearer tax policies, a simpler tax regime, and consensus that such a regime would the most appropriate for the financial sector and for IFS exports, three key principles come to the fore:

1. The need for applying a modern, low but universally applicable income tax regime across all sectors and activities, and a modern low VAT to avoid the prospect of smuggling and cash transactions compromising collections.
2. Confining taxation to resident income and consumption while exempting non-residents from all direct taxes (regardless of whether or not India has DTATs with their home countries). This does not mean exempting non-residents from indirect taxes on consumption of goods/services in the country. It does mean NOT creating a special tax regime specifically for non-residents under which they could arbitrage tax liabilities against their own tax regimes.
3. Removal of all bad taxes: *i.e.*, those that

lead to incentives for evasion, those that cost more to collect than yield, those that are discriminatory and distortionary, and those that create friction in the production of goods and services (*i.e.*, eliminate all transaction taxes such as stamp duties and transfer taxes on capital assets, particularly in financial transactions). As proposed in the Kelkar FRBM Task Force report, this needs to be done as part of the GST reform. The simultaneous removal of all bad taxes plus the introduction of the GST is fiscally neutral while enhancing both GDP and tax buoyancy.

For an IFC in India to be credible, tax-wise, to residents and non-residents alike, it is essential that the features, structures, rates and quantum of taxation in India should be consistent with:

(a) Optimising (not maximising) public revenue in line with the minimal financing of essential public goods/services – using a minimalist approach to defining what these should be and who should benefit from them
(b) Emphasising rapid output and high value-added growth over any other objective over the next 50 years
(c) Avoiding tax distortions, tax discrimination, tax exemptions and preferences altogether and adhering to the notion of universality
(d) Incentivising tax-payment 'volunteerism' rather than inducing tax avoidance and/or evasion by making it less expensive for taxpayers to comply instead of avoiding compliance; and
(e) Cost-effectiveness: *i.e.*, taxes should not be levied that are more expensive to collect at the margin than the amount of revenue they yield regardless of equity or social engineering concerns.

In achieving these objectives the question should be asked whether India's multi-layered political/administrative structures, at multiple levels of governance, and its traditional political/administrative practices, do not result in too many taxes being levied by too many different authorities at higher than necessary rates. The need to finance government at several levels should not be a reason to create and sustain (through inertia) a plethora of cascading and distorting taxes (such as stamp duties and octroi, which are a barrier to intra-country trade and movement of goods) with negative effects on output, efficiency and intra-country as well as international trade in goods and services.

In sum: the first issue to be emphasised in the context of a fiscal regime that would support India having an IFC– but one that has wider resonance and applicability – is that the most immediate objective in tax policy has to be to move rapidly towards a modern income tax and a modern VAT for universal applicability in India (and applied uniformly above practical thresholds). The second principle governing desired tax strategy is that no government should attempt to 'export taxes' or try to achieve extra-territoriality in the imposition of its tax regime. The incidence of a VAT should fall on domestic consumption only. With a well-designed VAT, imports are charged VAT, and exports are zero-rated, so that foreign customers of Indian goods and services do not pay VAT to the Indian government. The third principle is that bad taxes (no matter how politically attractive) lead to a weak, dysfunctional economy. They compromise fairness, growth and equity.

Once a framework of sound and low income taxes and VAT is created, the maze of distortionary taxes and exemptions that India has inherited from previous decades needs to be removed. In particular, turnover taxes matter greatly for export of IFS; their removal is directly material to the effort of India emerging as an IFC.

## 3. A modern income tax

At the level of broad principle, India should seek to roughly match the income tax treatment of a modern IFC such as Singapore, while avoiding the zero-tax approach of a city like Dubai. It should avoid attempting to have a dual tax regime for residents and non-residents specifically to attract IFS business.

### 3.1. What should the capital gains tax be?

An important debate now taking place in India that has considerable relevance for finance and IFS concerns the capital gains tax. Modern macroeconomic and public finance theories shed much light on the optimal conduct of monetary and fiscal policies. A robust result of the research literature suggests the need for low taxes on capital income (Chari and Kehoe, 2006; McCaffery, 2006). One of the foundation blocks of economic reasoning suggests that the goal of a sound fiscal system (especially in a developing country) should rely on taxing *consumption* not savings. This can be achieved by EET taxation with large permissible annual savings per person. Under such a scheme, individuals should be encouraged to save, with income and capital gains being exempt from taxation, until they chose to consume.

Thus, the path to a sound consumption tax lies in low or zero tax rates applied to capital income. Such an approach dovetails well with the export of IFS. Low or zero tax rates applied to capital gains would put India on par with many other countries that have taken such a path. But, this approach needs to be applied symmetrically to both domestic and foreign investors without creating officially sanctioned loopholes of the kind that exist in Indian tax treaties allowing special tax treatment for investors in Mauritius, Cyprus and Singapore. Many of these treaties will lose their potency in diverting tax revenues almost automatically with the removal of residual capital controls. It may be better to take that approach in dealing with the problems they appear to create than to attempt renegotiating them clause-by-clause. This overall approach to the taxation of finance would be consistent with Indian exports of IFS being rooted in the Indian financial system, and not separated into an enclave.

### 3.2. Mature issues in the Indian tax debate concerning finance and IFS

There are four specific areas of tax policy that influence IFS where the policy debate in India is mature and articulated in the Kelkar Report. These concern (1) tax treatment of savings, (2) taxation of asset management, (3) definitions and tax treatment of 'speculative' transactions and (4) the tax treatment of zero coupon bonds. The basic approach of the FRBM Implementation Task Force on these issues is entirely consistent with the goal of making Mumbai an Indian IFC.

From an IFS perspective, the primary priority is to bring about a liquid and efficient bond market with an arbitrage-free INR yield curve. Administered interest rates, and tax exemption provisions for particular financial products, militate against this goal. IFS exports are unlikely to materialise from India in the absence of its asset/fund management industry operating in the same way and being governed by the same policy regime as its global counterparts in other mature financial markets. That requires achieving 'neutrality' as an essential feature between 'in-sourcing' and 'outsourcing' of asset/fund management where three cases can be distinguished:

1. A firm or a person manages funds/assets
2. Funds are given to an AMC for asset management on an agency basis
3. A global AMC further subcontracts to other national/sectoral AMCs.

Tax considerations should not encourage or discourage the way in which the asset management business is organised in terms of the extent of outsourcing that takes place. As an example, corporations should have no tax-induced motivation to outsource treasury functions to mutual funds in an attempt to reduce their effective tax rates. Furthermore, tax considerations should not generate artificial differences in the relative attractiveness of alternative financial products, in the eyes of either providers or consumers of those products. As an example, an insurance company should not have to (or be allowed to) embellish an asset management product with a small actuarial component, in order to obtain superior tax treatment when compared with the same product being sold by a mutual fund or a private bank. Concessional tax treatment of certain savings instruments is particularly important insofar as it distorts price discovery for the INR yield curve. The adoption of a rational tax policy in these respects is inextricably bound to having an IFC emerge in India that is viable.

### 3.3. LLPs as tax-efficient pass-throughs

In creating sophisticated financial products or structures the need keeps recurring for a 'corporate or partnership' structure that supports tax-efficient transmission of cash-flows coupled with specific types of financial contracts. Internationally, such a structure is provided by the Limited Liability Partnership (LLP). Examples include:

- A securitisation special purpose vehicle (SPV) can be in the form of an LLP. It would be the placeholder for a certain contractual set of obligations through which cash-flows would come into the SPV. These cash-flows would be transmitted to the holders of securities issued by the SPV. The SPV itself would need to be a tax pass-through, while the cash-flows reach their eventual beneficial owners and get taxed in their tax-domiciles. If double-taxation takes place – if the cash-flow gets taxed once at the SPV and again in the tax domicile of the owner of the security – then securitisation cannot take place.
- 'Hedge funds' are invariably structured as LLPS. The lack of an LLP structure in India hinders the development of hedge funds as an institutional investing mechanism although these funds are now the mainstays of other IFCs. In disallowing them, India is doing enormous damage to itself.

Some development work towards getting LLP structures legitimised in India has been taking place, but it is more focused on the needs of professional services firms such as lawyers or accountants. Such development needs to take into account the needs of the LLP as a key building block of sophisticated financial structures.

## 4. Taxation of financial transactions

At present, there are three main kinds of transactions (*i.e.*, turnover) taxes in India that are applicable to financial transactions:

- The securities transaction tax (STT) applies to some kinds of securities: *e.g.*, equity spot and derivative transactions.
- Registration duties/fees need to be paid for specific services provided by government in recording contract and deeds. The government maintains a registry of deeds in return for a fee. Government agents (called 'sub-registrars') do not verify the legal validity of documents; they focus only on the payment of the correct fee. The payment of the registration fee does not entitle the payee to a guaranteed legal title.
- Stamp duty is a tax on the value of instruments used in various transactions.

All three of these are cascading taxes; they are comparable with excise taxes in the case of manufactured and traded goods.

### 4.1. Taxation of transactions distorts the conduct of business

In the real economy, it is now a well accepted principle that *turnover* is an inappropriate base for taxation. When transactions are taxed, this leads to a cascading impact. The incidence of such taxes falls to a greater extent upon processes that involve several stages of production. Transaction taxes encourage vertical integration *i.e.*, they encourage transactions to occur *within* the firm (rather than between independent firms) so as to incur lower taxes. This runs contrary to a key feature of a mature market economy, where firms are specialised to focus on core competencies, and where transactions take place between firms. Transaction taxes give firms a bias in favour of some production mechanisms over others: these biases distort the organisation of production and firms.

The identical issues apply in the taxation of financial transactions. A financial firm can be thought of as buying raw materials (securities or money on its assets side) in order to produce finished goods (securities on its liabilities side). The activities of a typical financial firm consist of a set of transactions that transform risk and return in a variety of ways to meet the needs of different customers. In finance, the trading strategy is analogous to *process technology*. Different technologies can be utilised to produce the identical product. In other words, a given set of risk/return characteristics can be produced through different trading strategies. As an example, if the goal is to produce a riskless asset with a maturity of 90 days, the different ways in which this can be done include:

1. Buy a zero-coupon government bond with a 90-day maturity
2. Buy a zero-coupon government bond with an 'n'-day maturity and rollover every 'n' days.
3. Enter into cash-and-carry arbitrage on one of many futures products.
4. Enter into put-call parity arbitrage positions using one of many options products.
5. Run an options book, and lay off risk, using delta-neutral hedging, dynamically modifying the hedge continuously so as to achieve zero risk.

These are only five examples of alternative technologies through which a riskless position with a 90-day maturity can be obtained. Numerous other 'technologies' for achieving this outcome can be designed, all of which combine underlying financial 'raw materials' through different trading strategies. Under normal circumstances, traders would decide among these different routes on the basis of commercial considerations. But, when turnover is taxed, the incidence of taxation falls disproportionately on 'technologies' that require more trading; even though they may be better options for investors to exercise. As an example, there might be a large degree of mispricing on the options market; but 'delta-neutral hedging' might be unattractive because it involves perhaps 100 times the trading volume when compared with buying a treasury bill. If transactions taxes applied, they would automatically tilt the investment decision toward sub-optimal purchase of a T-bill. A core principle of public finance is that tax policy must not modify the choice of technology by a private economic agent. Transaction taxes distort the choice of technology by financial firms. Therefore they are 'bad taxes'.

### 4.2. Taxing transactions in a world of IFS

Thus, in a purely domestic economy, the taxation of turnover is inappropriate because it violates every principle of sensible public finance. But the problems it creates escalate and multiply in the context of competing in global markets for IFS. Taxes on transactions force business to leave venues with effective high taxation (as well as high tax rates) and migrate to venues with low taxation (and low rates).

In the manufacturing world, the principle that *you cannot export taxes* is now well-understood. This has led to the entire sophisticated framework of VAT, where exports are zero-rated, and imports are charged VAT. Under this framework, the incidence of VAT falls only on domestic consumption. The price of all goods 'in transit' is free of VAT charged by any country. All mature market economies have eliminated all turnover taxes on goods. But, identical issues apply when it comes to the global market for IFS. It is not possible for India to impose taxes upon foreign customers of IFS produced in India: the attempt to do so will simply shift transactions away from India. **This clearly implies arguing for the removal of all taxes on transactions.**

### 4.3. Removal of turnover taxes in India

The removal of the Securities Transaction Tax (STT) will influence efficiency and export-competitiveness for IFS in a way similar to the removal of cascading taxes in manufacturing. There will be an initial loss of revenue; but this is inevitable with the removal of bad taxes. As an example, India steadily eliminated customs duties, which did hurt tax revenues. There was no attempt at introducing any compensating changes in the tax code, one-for-one, which compensated for the removal of the bad tax.

Sometimes, it is felt that a trade-off can be created between the taxation of capital gains and the taxation of financial market turnover. However, the unique historical features of India's evolution on both questions should not obscure the need for rational tax policy on both questions.

### Box 12.2: *Case Study on Swedish experience with transaction taxes, 1983–91*

The research literature suggests that transaction taxes can have negative effects on price discovery, volatility, liquidity, and lead to a reduction in the informational efficiency of markets (Habermeier and Kirilenko, 2003). One fascinating experiment with the introduction, and then the repeal, of a securities transaction tax took place from October 1983 to December 1991 in Sweden (Umlauf, 1993; Campbell and Froot, 1995).

Left-wing political parties in Sweden believed that trading on financial markets was an undesirable activity. It was argued that "*the salaries earned by young finance professionals were unjustifiable in a society giving high priority to income equality, especially given the seemingly unproductive tasks that they performed*". Despite the objections of the Swedish Finance Ministry and the financial industry, popular support led to the adoption of the STT by Parliament in October 1983, with effect from January 1, 1984. The STT was levied on domestic stock and derivative transactions. Purchases and sales of domestic equities were taxed at 0.5% each, resulting in a 1% tax per round trip. Round-trip transactions in stock options were taxed at 2%. In addition, exercise of an option was treated as a transaction in the underlying stock and, thus, was subject to an additional one percent round-trip charge.

The tax coverage and rates were based on populist notions about the *usefulness* of transactions in different financial instruments, with those involving equity options being seen as the least *useful*. Continuing pressure from the Left compelled Parliament to double rates in July 1986, and broaden its coverage in 1987. Furthermore, following large losses in interest rate futures and options (most notably by the City of Stockholm, which lost SEK 450 million), the tax was extended to transactions in fixed-income securities, including government debt and the corresponding derivatives in 1989. The maximum tax rate for fixed-income instruments was set at 0.15% of the underlying notional or cash amount. In addition, the tax was designed to be *yield-neutral*, with longer maturity instruments being taxed at progressively higher rates.

The empirical experience with revenues from STT was poor. When rates were doubled in July 1986, tax collections only went up by 22%. Customers were avoiding the tax by shifting their order flow to London or New York. The first thing which dried up was the order flow from foreign investors. Domestic investors avoided the STT by first establishing offshore accounts (and paying the tax equal to three times the round-trip tax on equity for funds moved offshore) and then using foreign brokers. The scale of avoidance was manifested by a massive migration of stock trading volume from Stockholm to other financial centres. Following the doubling of the tax, 60% of the traded volume of the 11 most actively traded Swedish stocks migrated to London. The migrated volume represented over 30% of all trading volume in Swedish equities. By 1990, that share increased to around 50%. Only 27% of the trading volume in Ericsson, the most actively traded Swedish stock, took place in Stockholm in 1988.

In the Swedish experience, revenues from the STT were poor for two reasons: shift in turnover to venues free of STT, and the decline in share prices associated with the tax and its impact upon market liquidity.

Broadening the tax to fixed-income instruments resulted in a sharp drop in trading volume in Swedish government bills and bonds and in fixed-income derivatives contracts. During the first week of the tax, bond trading volume dropped by about 85% from its average during the summer of 1987 and trading in fixed-income derivatives essentially disappeared. This significantly undermined the ability of the Bank of Sweden to conduct monetary policy, made government borrowing more expensive, and eroded both popular and political support for the tax. Taxes on fixed-income instruments were abolished in April 1990. Taxes on other instruments were cut in half in January 1991 and abolished altogether in December 1991.

Following the abolition of the tax, some trading volume came back to Sweden. By 1992, roughly 56% of trading in Swedish equities took place in Sweden. Once lost to other centres such trading volume becomes extremely difficult for countries to bring back home.

Modern economic reasoning suggests that there is merit in having both zero taxation of turnover and low-to-zero taxation of capital income. Discussions about the STT should not be undertaken as a trade-off with discussions about capital gains to achieve 'revenue neutrality'. That is a false trade-off.

The removal of stamp duty is part of the *Grand Bargain* proposed by the Kelkar Task Force. In exchange for tax revenues from *all* services, states should be willing to give up distortionary taxes like the stamp duty. In the case of real estate, the Kelkar Task Force report proposes integrating the real estate sector into the GST, which further enhances the case for elimination of stamp duty on real estate transactions.

In the case of registration fees, there is a role for the State in performing essential asset registry functions, and enforcing property rights associated with them. These functions are comparable to those of a depository on the markets. Registration fees can be interpreted as user charges for performing record keeping functions – which justifies small charges such as the per-transaction charge of NSDL. But the imposition of indirect taxes through registration and stamp duties constitutes a case of erroneous tax policy. There is a case for a user charge for operating and maintaining an IT system that maintains ownership records. There is no case for transaction taxes.

## 5. A Goods and Services Tax (GST) in Finance

The Kelkar FRBM Task Force report proposed the creation of a two-part VAT named the Goods and Services Tax (GST). What it envisages is a pair of taxes – levied by

Centre and States – that are harmonised in terms of tax policy and administration. The incidence of GST falls on *consumption* in the domestic economy; foreign consumers are not taxed. All parts of the economy – including the financial sector – would be covered by GST. This objective is consistent with both modern economic reasoning (Auerbach and Gordon, 2002) and with the establishment of an IFC in India. In the context of debates about treatment of domestic firms versus foreign firms, the GST comes down very clearly, seeking to have identical treatment of all firms.

From the viewpoint of Indian public finance, the emergence of an IFC in Mumbai would generate tax revenues through: (a) taxes on the income of individuals working in the IFS industry; (b) corporate income taxes applied to the firms operating in the IFC; and (c) the GST applied to value added by the industry when selling to local customers. Once these three sources of tax revenue are in place, it should become possible to simultaneously remove all turnover taxes, including stamp duty, registration duty and the securities transaction tax (STT).

Applying the GST to financial services is sound in principle. But the practical difficulties of achieving this outcome need to be better appreciated. The European Union pioneered building an EU-scale VAT on finance. Its experience has highlighted many areas of complex decision-making in tax policy and tax administration. India needs to approach the construction of a VAT on finance as a multi-year process, to be undertaken delicately and thoughtfully.

## 6. Mumbai as an IFC: Tax Implications for Maharashtra and Mumbai

This chapter underlines the principle that there is no role for taxation of transactions on financial services – whether for IFS or DFS (domestic financial services). Hence, neither Mumbai nor Maharashtra should expect a new revenue base emerging from large trading volumes of IFS in Mumbai. In fact turnover taxes (like stamp duties) levied on IFS transactions would ensure that there would, in all probability, be no IFS trading in/from Mumbai at all. Without stamp duties and other forms of 'local' taxation to capture, state and city politicians may ask: "What does Mumbai gain from having an IFC?" The answer is that:

- First, the two-part GST proposed involves a layer that consists of a consumption tax enforced at the State level. This would generate incremental revenues in proportion to the substantial incremental consumption opportunities created by having an IFC in Mumbai; *i.e.*, as a consequence of having more global financial firms locating in Mumbai to trade IFS and employing a far greater number of high-income people from Mumbai and abroad.

  That would create downstream opportunities for providing these incoming high-income firms and people with the usual range of incremental goods and services (from homes, to cars, refrigerators, washing machines, food, clothing, household linen and durables, domestic helpers, chauffeurs, peons, clerical workers, secretaries, finance professionals and paraprofessionals such as accountants, book-keepers, auditors, compliance officers, as well as restaurants, laundries, bakeries, clubs, cinemas, theatres, bookshops, hairdressers, fuel, gas stations, etc. *etc.*)

  But it would also have incremental costs: *i.e.*, by generating new needs for infrastructure (homes, office space, retail space, water, power, telecommunications, roads, sewerage, storm drainage, parking, airlines, airports, trains *etc.*), for law and order, security, and for physical/social recreation. Such investment could be made through PPPs thus saving the state and the city from making the actual investment necessary in creating such facilities.

  The additional demand created for goods and services by an IFC in Mumbai would generate a significant amount of additional revenue for the city and the state without having to resort either to directly taxing IFS transactions, or the profits of firms providing or trading in IFS. To the extent that an IFC in Mumbai increases general consumption – of both goods and services – it would generate substantially increased tax revenues indirectly.

But it would also demand better standards of governance to be provided (from policing to keeping public lavatories spotless and deodorised) by both city administration and the State government – governance that meets international standards. That would pose a greater challenge; one that should worry city/state (and central) government politicians and officials much more than the incremental revenues emanating from an IFC in Mumbai.

- To the extent that there are high productivity firms and individuals in Mumbai, this would support higher property prices and thus a bigger revenue stream from property taxes; especially if the market for owned and rented properties were to clear more efficiently in Mumbai than it presently does. The same is true for taxes from fuel consumption *etc.*

The benefit for state and municipal exchequers from having an IFC in Mumbai would be the enormous additional impact on prosperity in Mumbai and its surrounding region. It would not be seen through higher *direct* tax revenues. If there is any doubt about that then state and local politicians/officials should see for themselves first hand, the large incremental indirect benefits being derived in New York, London and Singapore by having an IFC located there. If such benefits were ephemeral it is certain that Dubai would not be pursuing the establishment of an IFC as aggressively and tenaciously – particular in inviting Indian financial firms to operate from there. Mumbai would have to be prepared to accommodate migrants not just from all over India but from the world who would be attracted by work opportunities in an IFC. Slogans and policies perceived to be 'anti foreigner' or 'anti expatriate' would do immense damage to the prospects of making Mumbai a viable IFC.

## 7. Interfacing tax policy and administration with the financial industry

The development of an IFC in Mumbai requires more vibrant interaction between Department of Revenue, the CBDT and the CBEC, with the financial services industry. This will be particularly necessary when the greater complexity of IFS provision escalates the complexity of tax policy and tax administration. A better institutionalised mechanism for interaction could yield a greater understanding of the ground realities of finance. This could influence tax policy, and practical problems of implementation could get more rapidly sorted out. Hence, there is a case for the Department of Revenue, as the agency responsible for tax policy, and the two implementation arms (the CBDT and the CBEC) to establish an Ombudsman function in Mumbai. Such an office would facilitate engagement by the financial services industry on one hand and the tax authorities on the other. It would enable issues of tax policy and consistency of its administration to be institutionalised. There is also considerable scope for these agencies doing some hands-on learning from cities like New York, London and Singapore in understanding how they deal with the same issues without disrupting IFC operations.

## 8. Stability of tax policy

From the viewpoint of India's aspirations to have Mumbai become an IFC, it is essential to emphasise the importance of stability and predictability of future tax policy. No firm – and financial firms least of all – likes to deal with uncertainty in making investment decisions and deciding where transactions will be booked and operating cash-flows registered. Global financial firms will require some assurance about the rationality and stability of the Indian macro-policy regime (on tax, capital controls, exchange rates, inflation, and monetary policy) in coming years, in order to make decisions about placing parts of their global IFS operations in Mumbai.

Table 12.1: Comparing India against existing IFCs on taxation

| Attributes, Characteristics and Capabilities of an IFC: (Scale of 0–10 with 0 = worst; 10 = best) | London | New York | Tokyo | Singapore | Frankfurt | Mumbai |
|---|---|---|---|---|---|---|
| **N. Taxation Issues as they affect the attractiveness of an IFC** | | | | | | |
| N1. Taxation of Resident Individuals working in the IFC | 5 | 4 | 3 | 5 | 2 | 5 |
| N2. Taxation of Non-resident Individuals working in an IFC | 7 | 5 | 5 | 6 | 3 | 6 |
| N3. Taxation of Resident Companies | 4 | 4 | 3 | 5 | 2 | 5 |
| N4. Taxation of Non-resident companies | 7 | 5 | 5 | 8 | 4 | 5 |
| N5. Withholding Taxes levied on financial instruments/transactions. | 4 | 3 | 3 | 5 | 3 | 5 |
| N6. Transactions Taxes on Financial Transactions – Domestic | 6 | 7 | 4 | 7 | 4 | 1 |
| N7. Transactions Taxes on Financial Transactions – IFS | 7 | 6 | 6 | 8 | 5 | ? |
| N8. Provisions for IBC or GBC licensing (*e.g.*, Delaware type) | 6 | 8 | 2 | 8 | 2 | 0 |
| N9. Taxation of IBC/GBC companies | 6 | 6 | 5 | 8 | 2 | 0 |
| **N10. Overall Taxation Environment** | **5** | **5** | **4** | **7** | **2** | **5** |
| N11. Complexity of Tax Laws, Codes, Rules, Regulations | 4 | 3 | 4 | 7 | 3 | 1 |
| N12. Effectiveness, Efficiency, Fairness and Corruption in Tax Administration | 9 | 7 | 8 | 9 | 9 | 3 |

Table 12.2: Comparing India against emerging IFCs on taxation

| Attributes, Characteristics and Capabilities of an IFC: (Scale of 0–10 with 0 = worst; 10 = best) | Mumbai | Hong Kong | Labuan | Seoul | Sydney | Dubai |
|---|---|---|---|---|---|---|
| N. Taxation Issues as they affect the attractiveness of an IFC | | | | | | |
| N1. Taxation of Resident Individuals working in the IFC | 5 | 8 | 5 | 4 | 4 | 10 |
| N2. Taxation of Non-resident Individuals working in an IFC | 6 | 10 | 10 | 7 | 7 | 10 |
| N3. Taxation of Resident Companies | 5 | 8 | 6 | 5 | 4 | 10 |
| N4. Taxation of Non-resident companies | 5 | 10 | 9 | 8 | 5 | 10 |
| N5. Withholding Taxes levied on financial instruments/transactions. | 5 | 10 | 9 | 5 | 5 | 10 |
| N6. Transactions Taxes on Financial Transactions – Domestic | 1 | 10 | 5 | 5 | 2 | 10 |
| N7. Transactions Taxes on Financial Transactions – IFS | ? | 10 | 9 | 8 | 6 | 10 |
| N8. Provisions for IBC or GBC licensing (*e.g.*, Delaware type) | 0 | 9 | 9 | 5 | 3 | 10 |
| N9. Taxation of IBC/GBC companies | 0 | 9 | 8 | 6 | 5 | 10 |
| **N10. Overall Taxation Environment** | **5** | **8** | **7** | **6** | **5** | **10** |
| N11. Complexity of Tax Laws, Codes, Rules, Regulations | 1 | 8 | 7 | 5 | 4 | 9 |
| N12. Effectiveness, Efficiency, Fairness and Corruption in Tax Administration | 3 | 8 | 7 | 6 | 8 | 9 |

As an example, the creation of a securitisation SPV may involve cash-flows for the coming 20 years or 40 years. If there is a risk of a major change in tax policy in that period then there is a reduced incentive to setup the SPV under Indian jurisdiction. The credibility of Mumbai as a potential IFC will be enhanced by having both (a) rational tax policy and (b) a framework that guarantees the *stability* of tax policy.

In the last decade, India has seen considerable changes in its tax regime, reflecting fiscal reforms that have been more far-reaching than is generally appreciated. Most of the changes made by the Centre have been in the right direction. Unfortunately, some of the tax changes made by States, to cope with their chronic fiscal incontinence, have been in the wrong direction. Few parts of the Indian economy have experienced as much progress as fiscal policy, with sharp reductions in customs duties, shift from turnover taxes to VAT, reduction of rate dispersion in indirect taxes, and lower income taxes. This paradigm shift in policy has been accompanied by far-reaching improvements in tax administration through computerisation, particularly with income tax and customs. But this progress has inevitably implied an environment of fast-changing tax policy. A particularly unhappy set of events has taken place on the tax treatment of dividends, where India has changed tax policy multiple times and created sufficient uncertainty about the future as to cause serious concern among global investors about policy stability.

From the viewpoint of creating a viable IFC, the recommendation of the Committee would be that a more specialised committee of tax experts familiar with IFS and the operations of global IFCs should now be created to translate the ideas of this chapter into detailed tax policies for specific IFS products and services, after which private agents should be encouraged to expect stability of tax policy for the deep future.

## 9. Where India Stands on taxes: An international comparison

In a pair of tables, we show a subjective comparison, where incumbent and emergent IFCs are rated on a scale from 0 to 10 on twelve measures of the tax policy and administration. When compared against established IFCs, the overall score of Mumbai (5) matches that of London or New York. But it fares poorly when compared with Singapore (7) and Dubai (10).