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Edits & Columns

A tax-and-spend Budget with good long-term initiatives for the capital market

Making the long view count

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It has been a tax-and-spend Budget, and neither the taxation nor the spending has been capital market-friendly. But the Budget contains some policy initiatives for the capital market that would enhance its vibrancy and efficiency in the long term. The enhanced dividend distribution tax directly hits the stock market. The extension of the minimum alternate tax to profits made in special zones as well as profits of 100% export oriented units impacts a sector that account for a large fraction of India's market capitalisation. Higher taxes on cement also have an adverse impact on the markets. The reduction in custom duties benefits the consumer, but is negative or at best neutral for the corporate sector. All these tax proposals are negative for the market.

Much of the spending, on the other hand, is concentrated on agriculture and social sectors, which are under-represented in the listed corporate sector. The Budget does promise an off-balance sheet boost to infrastructure, which could benefit many firms, but the benefits are far off.

That Budget 2007-08, overall, is negative for the capital market is reflected in the 4% drop in the market index on Budget day. Even if one attributes more than half of this fall to the sell-off in global markets, it is clear that the market has responded to the Budget itself with a drop of over 1.5%.

The long-term impact of the policy measures promised in the Budget is altogether different. Several of these measures have the potential to improve the depth, resilience and efficiency of the Indian capital market and must be welcomed.

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- Exchangeable bonds are a good idea, both as an additional financial instrument and as a mechanism for unwinding interlocked corporate holdings
- The elimination of tax arbitrage on mutual funds is probably a good thing in the long run

First is the proposal to allow institutional short selling and create a proper securities lending and borrowing mechanism for this purpose. This is vital for the long-term health of any capital market. Short selling often deflates price bubbles before they grow too large and therefore reduces the subsequent price fall as well. Short selling thus lowers volatility and reduces the incidence of sharp crashes. The only discordant note in the proposal is that the finance minister seemed to suggest that the securities lending scheme would be limited to institutions. This would be a bad mistake, and I hope that the government creates a mechanism accessible to all players in a non-discriminatory manner.

Second, exchangeable bonds are a good idea, both as an additional financial instrument in the marketplace and as a mechanism for unwinding interlocked corporate holdings. German conglomerates have used such bonds for this purpose, and they may work similarly here, too.

Third, the elimination of tax arbitrage on mutual funds is probably a good thing in the long run for the industry. Today, mutual funds use their tax advantage to serve the corporate market. As this advantage goes away, they will hopefully learn to compete on cost and performance to serve the retail market.

Fourth, the promise to move forward on making Mumbai a regional financial hub is welcome. This initiative announced in the 2005 Budget has gone through a tortuous process, with delays in committee formation and rumours of dissent within the committee itself. The FM's announcement hopefully means that we will see some real action backed by a strategic vision.

Fifth, I read the Budget speech as signalling a willingness to improve access of Indian investors to foreign securities both directly and through mutual funds. Today it is much easier for Indians to use the $50,000 limit to invest in foreign currency bank deposits than to invest in foreign stocks and bonds.

All of this means that we will have a cleaner, stronger and deeper capital market in the years to come. That is little consolation to those nursing stock market losses, but is hugely important for the future of India.

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