ILLUSTRATION: BINAY SINHA

Capital gains tax reforms in context

The budgetary provisions on the taxation of capital gains could help foster change in trading behaviour and address inequality

International mobility of capital, both by individuals and through corporations, has posed challenges to the ability of nations to tax capital income on a par with the taxation of relatively less mobile labour income. The G20's Base Erosion and Profit Shifting or BEPS project brought to the centre stage the issues related to corporations with a global presence, with solutions being proposed through administrative and taxation measures in the form of Pillar 1 and Pillar 2. This approach focuses on establishing a coordinated tax regime across countries, thereby reducing the scope for complete evasion/avoidance of taxes. Alongside these discussions, concerns on taxation of individuals, especially high-net-worth individuals, are also emerging.

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During the recent G20 meetings in Brazil, a proposal was presented for discussion — to levy a 2 per cent tax on the wealth of billionaires and, if possible, extend it to centimillionaires (*https://shorturl.at/F5gLl*). The paper presents some evidence from the United States, France, Italy and the Netherlands to suggest that the top 0.1 per cent in income distribution in different countries pay a lower fraction of their incomes as taxes when compared to the rest of the population. This anomaly is attributed to their higher abilities to undertake tax-planning. The solution to this concern is presented in the form of a 2 per cent global tax on the wealth of these individuals. The global component of the proposal is meant to reduce the scope for avoidance by relocation. The 2 per cent rate of tax on wealth, which is argued to grow at an average real rate of 6-7 per cent per annum, would imply a 33 per cent tax on income. Apart from addressing concerns of inequality, the proposal could be seen as a fair means for raising additional resources for financing sustainable development and climate goals.

While the willingness to levy such taxes as well as the specific form they might take can and will be discussed in various fora, the underlying concern of increasing inequality and the need to correct perceived differentials in the tax on capital and labour income is a more immediate concern. The Government of India has sought to introduce tax law changes to address such concerns even in the past — the shift of taxation of dividends from the company to the recipient was one such measure.

Another aspect that could drive policy interventions in capital markets are the structural changes in the ownership pattern in these markets. Low returns provided by the banking sector — both in nominal and real terms — have induced a shift in the incremental financial savings of households towards capital market investments. This process was nudged along by the temporary change in liquidity following demonetisation. This interest in capital markets is reinforced by the sharp increase in stock market returns (both in the cash segment and in the futures and options segment) along with easier access to investment opportunities provided by fintech developments. For instance, during FY2023-24, the Nifty grew by 26 per cent while the Sensex grew by 24 per cent. For the last five years, the average annual increase in these indices is about 16 per cent. In contrast, interest rates on fixed deposits have not crossed 10 per cent at any time.

The structural change is reflected in the fact that the share of mutual funds in total market capitalisation has increased from 4.9 per cent in FY17 to 8.9 per cent in FY24. The Economic Survey reports that individual investors' share of the turnover in the equity cash segment in FY24 is 35.9 per cent. An examination of the composition of financial savings of households shows that shares and debentures on average account for 6.8 per cent of total financial savings of households in recent times, up from 1.6 per cent pre-FY16. Correspondingly, the share of deposits has fallen from 51 per cent to 36 per cent.

Another aspect to consider is the possible impact of buoyant financial markets on investment decisions in the real economy. High returns on stock market investments could make real investments with modest returns unviable or unattractive. A look at the combined balance sheets of 10,639 private limited companies released by the Reserve Bank of India shows a decline in the share of gross fixed assets in total assets from 48.2 per cent in 2020-21 to 46.8 per cent 2022-23, alongside an increase in the share of equity instruments and shares from 8 to 8.7 per cent.

The budgetary provisions on the taxation of capital gains and the securities transactions tax need to be understood in this context. Budget 2024-25 proposes an increase in tax on both short-term capital gains and long-term capital gains on listed stocks — the former increasing from 15 per cent to 20 per cent and the latter from 10 to 12.5 per cent. In addition, the securities transaction tax on futures and options transactions too has been increased. These could be seen as a step towards reducing the differences in taxes on capital and labour incomes. The change in the tax treatment of buyback of shares too contributes to a widening of the tax base with the liability being imposed on capital incomes. On the other hand, higher taxes can moderate the returns to speculative investments in capital markets. An increase in the tax differential between short-term and long-term capital gains could induce longer-term holdings. More modest returns in capital markets could lead to greater stability and better support for real investments in the economy.

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