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## RESEARCH ARTICLE

## COMPARATIVE STUDY OF GLOBAL AND INDIAN COST OF TRADING

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**Abstract**

The aim of the present study is to analysis the cost of trading in emerging market like India with respect to the international market in the world. The study is purely based on the secondary data and main source of cost analysis is taken from the NSE. Through this comparative study we find that even now the India stock market is having a higher cost of trading as compared to other emerging and developed market in the world. So, it is advisable to reduce the cost of trading which will result in increase in market volume and attract more foreign investors to India.

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**1. Introduction**

Capital market provides platform for selling and buying of the stock and this selling and buying will not directly done in the exchange in India but it is done through a depository participate who is also known as Broker. When investor buy or sale a securities in the stock exchange he or she will not only pay the price of the securities traded in the market but have to pay some additional cost which is known as cost of trading. Cost of trading play an important role in movement of capital in global market from one market to another market. If the cost of trading is high it is term as inefficient financial system and will be suffer from lack of investment from global market.

Cost of trading is composed of user charges, statutory levies and impact costs.

**1.1 User Charges**

An investor/trader is required to pay user charges in return for the facility to use the infrastructure of three separate entities: brokers, stock exchanges and depository service providers; the charges made by these entities are brokerage fees, exchange transaction charges and depository charges respectively. The exchange transaction fee also includes the costs of clearing and settlement, undertaken by the clearing corporations. The depositories provide depository services to investors through depository participants (DPs). They do not

charge the investors directly but charge their DPs, who are free to have their own fee structure for their clients. It may be noted that each of these three entities—brokers, exchanges and DPs—are for profit entities and what they charge to the clients includes an element of profit. Bulk of the user charges is of ad valorem nature; that is, they are applied on transaction values.

**1.2 Statutory Levies**

Transactions on exchanges attract four different types of statutory levies; they are: Securities Transaction Tax (STT), Service tax on brokerage, Stamp duty and SEBI turnover fees. STT and service tax on brokerages are revenues of the Central Government, while stamp duty is collected by respective state governments. SEBI turnover fees flow into SEBI General Fund. SEBI's budget is financed by this Fund. The base for all these levies is transaction value, except for service tax on brokerage, which is applied on the brokerage fees charged by the brokers. It may also be noted that all the levies are uniform across the country, except stamp duties, which are payable as per the rates prescribed by the state in which a transaction takes place.

### 1.3 Impact Cost

Impact cost is an indicator of liquidity of a market. It arises because of the absence of perfect liquidity in the markets in the real world. The less liquid a market, the higher is the impact cost.

## 2. Relative contribution of different cost components

Costs of trading vary depending on a number of factors such as type of trade (delivery based or not),

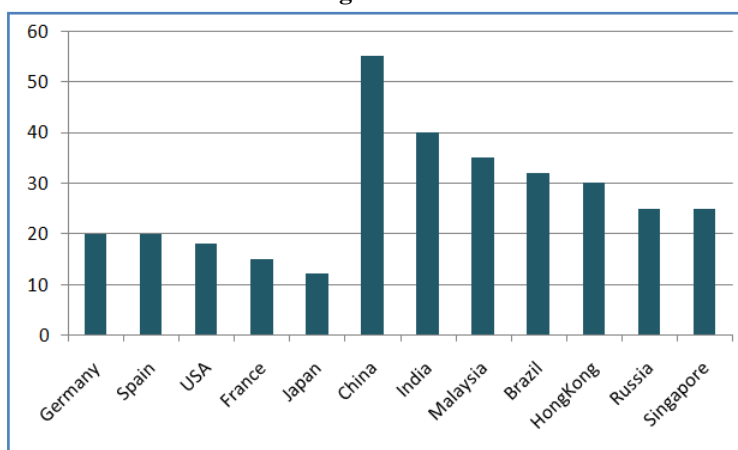
kind of security being traded (equity or debt or derivatives), type of investor (retail vs institutional), size of transaction, location of the broker and so on. To arrive at any estimate of total trading costs, one would necessarily have to make assumptions on these factors. Based on a certain set of assumptions, we have estimated the costs of trading securities valued at Rs 100,000 at NSE

**Table-1: Transaction cost for trading in securities market (Average brokerage@10bps)**

Value of the trade	Rs 1,00,000		
	Cost (Rs)	% of Total cost	Basis points of Traded Value
<b>User Charges</b>	<b>123.25</b>	<b>38</b>	<b>12.38</b>
of which:			
Brokerage (at the rate of 10 bps)	100	31	10
Exchange Transaction Charges	3.25	1	0.3
DP charges	20	6	2
<b>Statutory levies</b>	<b>145.5</b>	<b>44</b>	<b>14.5</b>
of which:			
Securities Transaction Tax (STT)	125	38	12.5
Service tax on brokerage (@10.3 %)	10.3	3	1
Stamp duty	10	3	1
SEBI turnover fee	0.1	0	0
<b>Impact Cost</b>	<b>60</b>	<b>18</b>	<b>6</b>
<b>Total</b>	<b>328.65</b>	<b>100</b>	<b>32.82</b>

Source: NSE staff estimation

**Chart-1: Overall trading cost of select countries in 2009**



Developed Markets

Emerging Markets

Source: Standard and Poor's, "Global Stock Markets Factbook 2010"

### 3. High securities transaction tax—a matter of concern?

Securities transaction taxes were rationalized to some extent in 2008, but it continues to be very high (0.125 percent) in case of delivery based transactions in equity and upon exercise of options. Now, why a tax rate of 0.125 percent is considered high; are not the other tax rates higher, whether in India or abroad? Compared to most tax rates, 0.125 percent might seem low; however, because the tax base is gross transaction value, rather than net income from a trade, 12.5 basis points in practice is very high. Clearly, to address India's still (relatively) high trading costs, it is necessary to review the tax regime (governing the securities transactions), particularly the STT. But is there any economic rationale for such a move?

To answer this question, it would be useful to know why STT was introduced. In 2004, to simplify the tax regime on financial market transactions, STT (considered a clean, efficient and easy to administer instrument) was introduced, while the tax on long-term capital gains was abolished and the short-term capital gains reduced from 33 percent to 10 percent. 56 As we observed, the STT rates have generally been raised progressively over the years, probably because of the ease in collection of a tax whose base has been rising rapidly over the years.

There are, however, two reasons why the STT regime in India needs to be reviewed. First, the revenue received by the Government from this source has been negligible—in the range of 0.1-0.2 percent of GDP. Predictably, the STT revenue rises or falls with financial market activity; in 2007, for example, when the market had boomed, the STT revenue peaked at 0.19 percent of GDP. Even so, it is unlikely that it can ever generate much higher revenue as percent of GDP. It is useful to note that France, Germany, Japan and Italy, which eliminated their stock market transaction taxes in the last two decades, collected at most 0.2 percent of their GDP.

Second, would it then be possible to raise revenue from this source by raising the tax rate? It is difficult to answer this question, as it would depend on a large number of factors. It is however useful to note that given the ever increasing integration of the world financial markets, it is possible that relatively high STTs could drive out financial activity to other countries. Also, a hike in STT rates discourages trading volumes in any given country. This can be explained with an example. If STT is  $X\%$  of the value of a security, for a person to make profit out of trading, the security price must increase by at least

$2X$  percent, because the trader has to both enter and exit to make profit. In case of situations, where STT is applicable either on buyers or on sellers, the security price needs to rise by more than  $X$  percent for the trade to be profitable. In either case, as STT rises, the chances of a trade being profitable reduce and traders are discouraged to trade. While this is true of other components of trading costs as well, our focus is on STT, because we have seen that it is primarily the STT which has been putting upward pressure on total trading costs. Besides, traders are particularly sensitive to statutory levies than other trading cost components, such as brokerage, exchange transaction fee and DP charges, where choices are available. It is for this reasons that high STTs can and do affect trading volumes; lower trading volumes in turn reduce liquidity and slow price discovery. In India, there is strong evidence that trading volumes in securities markets are highly sensitive to the tax regime. Index options, which were introduced in June 2001, remained unattractive because of high tax burden till June 2008. In June 2008, when the STT tax burden on option contracts was reduced by changing the tax base from notional value of option contract to option premium, trading volumes immediately picked up and today India is among the top few countries in the index option trading. This underscores the impact that turnover taxes can have on the build-up of liquidity and usage of financial instruments.

### 4. Summary and conclusion

In this paper, we have seen that in line with the global trend, the cost of trading in Indian exchanges has declined over the years. Yet, trading costs in India remain comparatively high as compared to other countries. Because trading occurs on the exchange platform, there is a perception that the exchange as the intermediary in trading transactions is responsible for this. A decomposition of total trading costs debunks this myth, as exchanges account for a miniscule part of total trading costs. Further, an analysis of the trends of various components of trading costs shows that while the user charges (that is, charges made by brokers, exchanges and DPs) and impact costs have declined, the statutory levies, particularly the STT rate has risen. While there is no need for complacency for the market infrastructure service providers to further reduce the trading costs, there appears to be a case for review of the STT regime, as there are concerns that it may be raising businesses' cost of capital and impairing the development and competitiveness of domestic financial markets, given increased cross border mobility of capital. At the same time, the objective of revenue collection is not found to be well

served by STT, although it is often cited as the rationale for its imposition.

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