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`Tax not best way to curb contra deals'

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A CAPITAL gains tax on share transactions may not be the most effective way to control "contra" activities, not least in view of the "bad name" it has among investors, analysts say.

One problem with a capital gains tax is where it should be imposed. If the onus is on the investor to declare the gains, there will be problems with enforcement. If the tax is deducted at the broker level, gains can always be offset against other transactions, they said.

Instead, stock speculation can be more effectively discouraged by raising required margins, maybe even 100 per cent, or close to that. Imposing a limit on margin loans is another possibility, Kompleks Metrowangsa Sdn Bhd managing director Dr Ghazali Atan said.

"This means that investors must have the money to trade. It is easier to implement ... capital gains tax has a bad name to it," he told Business Times.

In the longer term, a professional fund management industry, which includes unit trusts, can be developed to the point where direct speculation is no longer viable, Ghazali added.

This can be done by having higher commissions for smaller trades, he said. Along the same lines, minimum trades can also be imposed.

The issue for the authorities will be one of balancing the need for liquidity, which in the past was mostly generated by small and often speculative retail investors, and that of curbing excessive speculation, he said.

On the one hand, liquidity and the freedom to invest or divest are what keep a stock market alive and growing, Ghazali said. On the other, unbridled speculation can pose systemic threats.

Prime Minister and First Finance Minister Datuk Seri Dr Mahathir Mohamad had last Thursday said the Government might consider imposing a capital gains tax or other similar measures to control contra activities, which have been identified as a major cause of the stock market's volatility.

Most Asian stock exchanges are heavily retail-driven and do not impose a capital gains tax. Indonesia had one until 1995, and replaced it with a transaction tax of 0.1 per cent.

Taiwan abolished its capital gains tax in 1990, but reintroduced it in 1996. Share trade gains are taxed 14 per cent, but only half of the amount will be taxed if investors hold their shares for more than one year.

The taxes are more common in the developed markets. The US Taxpayer Relief Act 1997, as it applies to stocks, sets the maximum tax rate for stocks held more than 18 months at 20 per cent. For stocks held for a year or less, the gains tax is as high as 39.6 per cent, and for stocks bought after the year 2000 and kept for at least five years, the rate drops to 18 per cent.

A capital gains tax is not positive for the market at this time, another analyst with a local stockbroking house said. The regulatory authorities should just proceed with their proposed gradual shortening of the settlement period for share transactions, she said. It has already been reduced from T+7 to T+5, and is targeted to be reduced to T+3 or T+2 in line with international standards. Hong Kong, which does not have a capital gains tax, currently trades on T+2.

"This by itself should be enough to help reduce contra activities," she added.

The head of research at another local brokerage said imposing the tax now would not be in line with the strategies that the Government is putting in place to spur economic recovery. Having adopted the China model to insulate the economy, the market is expected to be mostly domestic driven.

"This means that the speculative element must be there ... but too much. In the longer term, people should look to unit trusts as intermediaries for their investments," he said.

If the tax is introduced, investor sentiment will surely be affected, but only in the short term. The market will move up even without contra trades, he added. This is because the fall in interest rates has made fixed deposits less attractive and the property market has yet to pick up, which means the best returns are still from investing in the stock market.

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