Budget (2017-2018) and its impact on the Capital Market:

Evidence from Dhaka Stock Exchange

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Abstract

This study discusses the pre-budget and post budget scenario of budget (2017-2018) from the perspective of capital market. It attempts to identify the expectations of stakeholders based on pre-budget demands by stakeholders and hint from policy makers. By analyzing pre-budget discussions and observing the reactions of the market to any hint provided by policy maker, it can be inferred that, corporate tax reduction is considered as an important factor by the stakeholders of capital market. The study provides examples of some countries with less than 25% corporate tax and higher market capitalization to GDP. It is found that some issues in proposed budget did not match the expectations of stakeholders. For example: demands of full tax exemption of exchanges, reducing VAT and corporate tax, widening corporate tax gap between listed and non-listed companies, increasing tax free dividend ceiling were not addressed in the budget. On the other hand some indirect incentives were given: tax exemption to BSEC and making capital market services free from VAT. By observing post-budget turnover and movement of index, it was found that investors of Bangladesh acted positively.

Keywords: Budget, Capital Market, DSE and Index.

Introduction:

Impact of fiscal policy on capital markets of different countries is evident from various literatures. Studies showed influence of corporate tax, size of budget and other factors on the growth and return of stock market. In Bangladesh budget speech is presented every year in the month of June. Pre-budget discussion with stakeholders is held every year ahead of budget announcement. Stakeholders of capital market also make some proposals in pre-budget discussion. These proposals along with the hints provided by policy makers from time to time create expectations among investors. These expectations tend to affect mean return, volatility and turnover of market. After the budget announcement, investors compare the reality to their previous expectations. This may lead to change in market scenario during post-budget period. This study intends to discuss the pre-budget demands, pre-budget expectations and impact on market. The study also discusses the key decisions related to capital market as announced in budget speech and their potential impact on stock market.

Literature review:

Tirimba et al. (2015) reviewed 66 literature regarding different types of incentives for investment in stock market. One of those incentives is tax incentive. Various countries used fiscal policy incentives to promote capital market performance. The study cited example of Kenya. There was a reduction in the corporation tax rate for newly listed companies on the Nairobi stock exchange. The corporation tax rate decreased from 30% to 25% over a five-year period starting 1st January 2002. Literatures depict relationship between fiscal incentives and higher investment in several countries, including Ireland, Mauritius, and Singapore. According to the study, tax incentives as well as investors' perceptions have effects on performance of stock market. Reducing tax rates aids boosting foreign direct investment. A good investment climate in the country makes the influence eight times stronger.

Anghelache, Jakova, & Oanea (2016) analyzed the Anghelache et al. (2016) analyzed the association between fiscal policy and capital market performance in 6 European Union (EU) countries from Central and Eastern Europe, for period 2004 - 2015. The research found that fiscal policy and capital market performance influences each other in Czech Republic and Slovakia. In Bulgaria the study found that the fiscal policy influences the capital market return. Djankov et al.(2010) presented relationships between corporate taxes, investment, and entrepreneurship for 85 countries. The study found that effective corporate tax rates have a significant negative effect on corporate investment. Higher effective corporate income taxes are associated with lower investment in manufacturing sector.

As cited by Tirimba et al. (2015), in a survey carried out by the IOSCO (2002), it was revealed that incentives build up investors' confidence and promote investor participation. In Mauritius, new investors were attracted when incentives were introduced. In Lithuania incentives cause to increase stock trading. Chopra et al. (1992) showed, in the Lima Stock exchange of Peru, incentives account for the increase in the amount of trading stock.

Objective of the study: If the stock market is efficient, it will response rationally to all information. Bangladesh capital market is not an efficient market and it needs to be examined whether capital market is responding to the budget rationally or not. This paper will try to observe how capital market responds to budget announcement (2017-2018).

Methodology: This study attempts to analyze the pre-budget and post budget scenario of budget (2017-2018) from the perspective of capital market. It tries to identify the expectations of stakeholders by exploring secondary sources. It analyzes pre-budget discussions and observes the reactions of the market to any hint provided by policy maker. We observed the changes in stock market index and turnover for thirty working days ahead of budget speech. The study attempts to analyze the decisions of budget regarding capital market and their potential impact on capital market. We also observed how market reacted after budget speech. In this purpose, this study takes into consideration both market index and turnover of ten post-budget days.

Discussion and analysis:

Pre-Budget demands related to capital market (2017)

Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE) authority put forth their demands in pre-budget discussion with the National Board of Revenue (NBR) on 08 April, 2017.

Widening corporate tax gap between listed and non-listed companies: Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE) authority requested to increase the corporate tax gap between listed and non-listed companies. In 2016-2017 the gap was 10%. An increase in the gap will motivate good companies to be listed on the stock market. As a result, market capitalization will increase. Widening gap may also have positive impact on the profit of listed companies. If the companies can earn more profit they will be able to distribute higher dividends to the investors.

Increasing tax-exemption ceiling for dividend paid by investors to Tk 0.1 million from Tk 25000: This incentive is proposed to encourage investors' participation. This may motivate long-term investment by small investors. For ensuring stability in capital market long term investment is imperative. DSE also proposed to introduce tax ceiling on holding share for years. It would encourage long-term investment.

Providing a three-year full tax exemption on the annual income of stock exchanges: DSE and CSE urged the Government to provide a three-year tax-break on their annual incomes to support them attaining financial stability after the demutualization. They also sought a waiver of tax on sales proceed of shares and capital gain on block shares.

Reducing the rate of source tax on trade volume: Proposal has been made to reduce the advance income tax (AIT) on trade volume from existing 0.05% to 0.015%.

Merchant Bankers Association representative also made some proposals. They proposed to bring uniformity on corporate-tax rates between asset management companies and other similar types of financial entities. Merchant banks have to pay corporate tax at 37.5 per cent. They also demanded reduction in capital-gains tax for merchant Bankers from 10 percent to 5.0 percent. Federation of Bangladesh Chambers of Commerce and Industry (FBCCI) on 30 May 2017 at the joint advisory meeting between the NBR and FBCCI proposed making the corporate tax on listed companies to 22 per cent from 25 per cent. It also proposed to reduce tax on listed banks, insurances and other financial institutions to 37 per cent from the existing 40 per cent.

Pre-budget expectations (2017-2018):

On the basis of hints provided by the policy maker, different expectations were created among investors, in pre-budget days.

On 1 May, at the joint advisory meeting between the National Board of Revenue (NBR) and the Federation of Bangladesh Chambers of Commerce and Industry (FBCCI), the Hon'ble Finance Minister expressed that, he was contemplating reduction of corporate tax this time. At the same meeting, he hinted reducing Value added Tax by 1-2%. The motivating hint created positive expectations among investors. Positive vibe was observed in the very next day. On 02 May 2017 turnover raised by 25.95% and DSEX index increased by 0.84%.

On 27 May 2107, changing the earlier declaration it was said that the VAT rate would remain unchanged at 15 per cent in the upcoming budget. No reduction in corporate tax rate was also hinted. The immediate effect of this news was observed. On the next trading day, turnover reduced by 30.64% and DSEX index lost 0.83%.

From Figure-1 and Figure-2, we can see that, on 02 May 2017, both market index and turnover rose due to positive hint from policy makes regarding reduction of VAT and corporate tax. On the contrary, on 28 May 2017, negative changes

Figure-1:

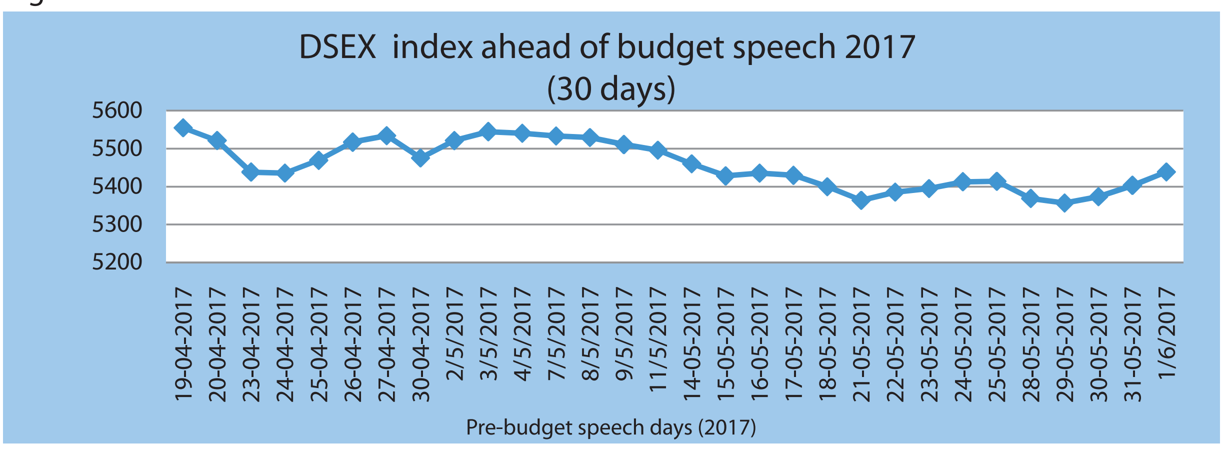
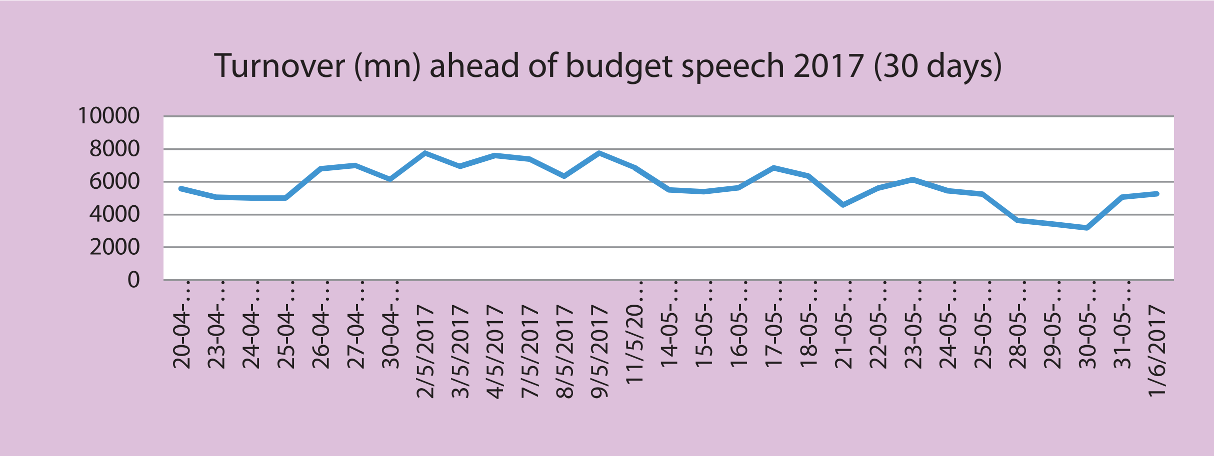


Figure-2:



were observed in both market index and turnover as policy makers altered previous announcement and hinted no change in VAT and corporate tax.

There are other factors besides pre-budget expectations that influenced the market. For example, on 21 May 2017 the hint of reduction of the interest rate of national savings certificates drove market in a positive direction

Decisions related to capital market as announced in 'Budget Speech' and their potential effects on the market (2017-2018):

Tax exemption is proposed for BSEC: Bangladesh Securities and Exchange Commission has been exempted from tax in order to make a positive impact on capital market. Full tax exemption for the regulator has been proposed for the next five years. Tax exemption of BSEC is not directly related to the performance of capital market. But it is positive news for capital market. It will motivate BSEC's endeavor to promote transparency and efficiency of capital market.

Capital market services are proposed to be VAT free: All kinds of services at the capital market have been kept VAT free. The Government has exempted the stakeholders from the Value added Tax (VAT). Examples of VAT free services are: renewal of TREC (Trading Rights Entitlement Certificate) and license of brokers and dealers, CDBL fee, annual fee of merchant bankers and trade certificates of sale representatives. This decision is not directly related to market performance. But inspired stakeholders may play positive role for betterment of performance of capital market.

Corporate tax rate has been kept all most unchanged: The existing corporate tax rates have been kept unchanged. The corporate tax rate for non-publicly traded companies is 35 percent. For listed company the rate is 25%.This 10% difference in tax rates is maintained for encouraging the companies to be listed with the stock exchanges. The corporate tax rates are given in Table-I.

Table-I: Corporate tax rates as per budget speech 2017-2018

Description	Proposed rates
Publicly Traded Company	25 percent
Non-publicly Traded Company	35 percent
Publicly traded Bank, Insurance and Financial Institution (other than Merchant Bank)/ Newly established Bank, Insurance, and Financial institutions approved by government in 2013	40 percent
Non-publicly traded Bank, Insurance and Financial Institution	42.5 percent
Merchant Bank	37.5 percent
Cigarette, bidi , zarda, chewing tobacco or other tobacco products manufacturing company	45 percent
Mobile Phone: Publicly Traded Non-publicly Traded	40 percent 45 percent
Dividend Income	20 percent

In case of textile industry, eco-friendly Company will get a little tax advantage. Normal tax rate was 15%. According to the new budget, normal tax rate is same but for environment friendly company, it will be 12%.

This study attempts to look into the corporate tax rate and market capitalization to GDP in various countries.

Table-II: Corporate tax rates and market capitalization to GDP% in various countries in Asia

Stock Exchange	Corporate tax % (2017)	Market Capitalization to GDP % (March 2017)
BSE (India)	30	83.43
Bursa Malaysia	24	130.40
Colombo SE	28	21.47
DSE (Bangladesh)	25	18.49
Hong Kong Exchanges	16.5	1108.93
Indonesia SE	25	48.33
Pakistan Stock Exchange	31	34.12
Singapore Exchange	17	241.81
Taiwan SE Corp.	17	184.41
Thailand SE	20	117.53

Source: KPMG's Corporate Tax Rate Table and DSE Monthly Review

From Table-II, we can see, countries having corporate tax rate less than 25% have relatively higher market capitalization to GDP. The market capitalization to GDP% of Bangladesh is 18.49%, which is very low. New companies should be attracted to be listed in DSE and CSE to enhance the size of Bangladesh capital market. Listing of new good quality companies is also essential for elevating the strength of the market. A reduction of corporate tax may attract companies to do business in Bangladesh and be listed in the market.

If investors perceive any incentive as an important factor, then changes in stock market performance take place (Tirimba et al., 2015). It is observed in pre-budget days that, corporate tax is perceived as an important factor by the investors. Hint of not reducing corporate tax and VAT had an immediate negative impact on turnover and index. (Chopra et al., 1992) as cited by (Tirimba et al., 2015) have found out that investor perceptions affect the stock market directly since the participants of the stock markets are humans who are led by emotions and attitudes. So, investors' expectation can affect the market. As the disappointment of investors for not reducing corporate tax has been already reflected in pre-budget days, further negative impact is not expected in post budget days.

No decision has come regarding extension of full tax exemption for exchanges, increasing the ceiling of tax-free dividend income and reduction of AIT: The leaders of both exchanges demanded continuation of full tax exemption facility for three years, increase the ceiling of tax-free dividend income to Tk 100,000 from the existing Tk 25,000 and reduction of tax at source on share transactions to 0.015 per cent from existing 0.05 per cent. But, it did not get any attention in the proposed budget. This may lessen the enthusiasm of stakeholders for some time.

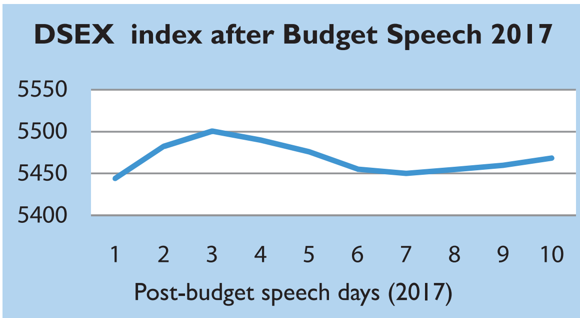
Tax waiver is given to alternative investment fund: The income of Alternative Investment Fund (AIF) will enjoy tax waiver as long as the income belongs to fund managers and trustees. During disbursement, the income of AIF will be considered as dividend and tax will be imposed on that dividend. This is a positive measure for the development of capital market to motivate alternative investment funds.

The biggest budget in the county's history has been announced: The size (Tk 400,266 crore) of the proposed budget 2017-2018 is the biggest in the history of Bangladesh. An expansionary budget has a positive effect on capital market. Expansionary fiscal policy creates demand. Demand augments corporate profits. From this point of view, the proposed budget will have a positive effect on the capital market.

Incentives are provided to some industries: Benefits of reduced tax or reduced duty in importing raw materials are provided to some industries. Benefited industries are: textile, leather, agriculture, food and allied (fish, poultry and dairy), medicine, local ceramic companies, fuel. Zeal of investors in buying stocks of these sectors is anticipated. On the other hand tobacco may suffer due to higher tax.

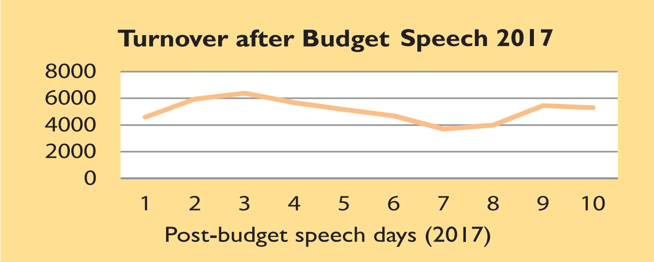
The proposed budget 2017-2018 has provided some indirect incentives to capital market. Examples of these incentives are: tax exemption of BSEC, VAT exemption of capital market related services, tax waiver to alternative investment funds etc. Though unaddressed demands including reduction of corporate tax created pessimism among investors, other positive news brought back investors' optimism .The announcement of cutting interest rate of saving instruments also acted as a catalyst to create enthusiasm among investors. In post budget days, active participation of investors was witnessed with rise in turnover and market index.

Figure-3:



From Figure-3 we can see, market index increases for four days in after budget speech 2017.

Figure-4:



From Figure-4 we can see, in the immediate day after budget speech (2017-2018) turnover decreased but it rose in the next couple of days.

Table-III: Turnover and market return in pre-budget and post-budget days

Indicators		Pre-budget days (5days including budget speech day)	Post - budget days (5 days)
Turnover (in mn Taka)	Average	4111.13	5560.09
	Standard deviation	974.54	696.37
Market return (% change of DSEX)	Average	0.09%	0.14%
	Standard deviation	0.62%	0.40%

From Table-III we can see, both index and turnover of post-budget days (05 days) is greater than those of pre-budget days (05 days including budget speech day) on an average. Volatility (standard deviation) also decreased in post budget days with the exclusion of uncertainty.

Conclusion:

Government grants incentives with a view to influence investment decisions positively. Along with the incentives, investors' expectations play vital role in bringing changes in capital market performance. This study compares decisions of policy makers as announced in Bangladesh budget speech 2017 with the expectations of investors of capital. Among other demands, corporate tax reduction got importance. This study found this demand as a rational one and cited examples of some countries with less than 25% corporate tax and higher market capitalization to GDP. The aim of providing incentives is to promote stock market performance. The size of Bangladesh capital market is very small compared to GDP. For development of market, new companies should be attracted for listing in the market. In this purpose, reduction of corporate tax for listed companies was sought by stakeholders. However, along with some other demands, expectation of reduced corporate tax has not been met. But negative impact of this unmet demand had been already reflected in pre-budget days based on hint by policy maker. Investors' zeal has been rebounded after budget speech with some indirect incentives for capital market. The decisions that are expected to affect capital market in a positive manner are: tax exemption to BSEC and making capital market services free from VAT. The reflection of these positive measures was witnessed with the raise of turnover as well as market index.

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