

Tax Threat and Disruptive Market Power of Foreign Portfolio Investors

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Introduction: Importance of FPIs



- The **importance of FPIs**, particularly for the capital constrained emerging markets, is well documented in literature
- Regulators often **shape policies** that attract and support FPIs.
- Recent evidence suggests that FPIs themselves can **influence policymaking**
- We extend this literature by arguing that FPIs also possess **direct market-based means of instituting changes** in the domestic policies

Tax Threat: Media Coverage



THE TIMES OF INDIA BUSINESS

News Home » Business » India Business

100 FIIs get tax notices for \$6bn, say it's retrospective

TNN | Apr 6, 2015, 01:08 AM IST

FINANCIAL TIMES

UK COMPANIES MARKETS OPINION WORK & CAREERS LIFE & ARTS

Foreign funds brace for India's alternative tax demand

Orders received by about 100 funds prompt concern country's tax authorities targeting global investors

QUARTZ India

HARD TIMES

India's unclear tax policy has come back to haunt Modi

FINANCIAL TIMES

UK COMPANIES MARKETS OPINION WORK & CAREERS LIFE & ARTS

More foreign funds to face India tax demands

Looming notices set to heighten concerns that global investors are heading for a row with New Delhi

THE ECONOMIC TIMES Policy

Sebi backs foreign portfolio investors, raises concern over impact of MAT

LATEST NEWS Government announces 1 lakh crore for Tamil Nadu

THE TIMES OF INDIA BUSINESS

News Home » Business » India Business

Government to press ahead with Rs 40,000 crore tax demand on FIIs: Arun Jaitley

TNN | Apr 15, 2015, 02:07 AM IST

THE WALL STREET JOURNAL.

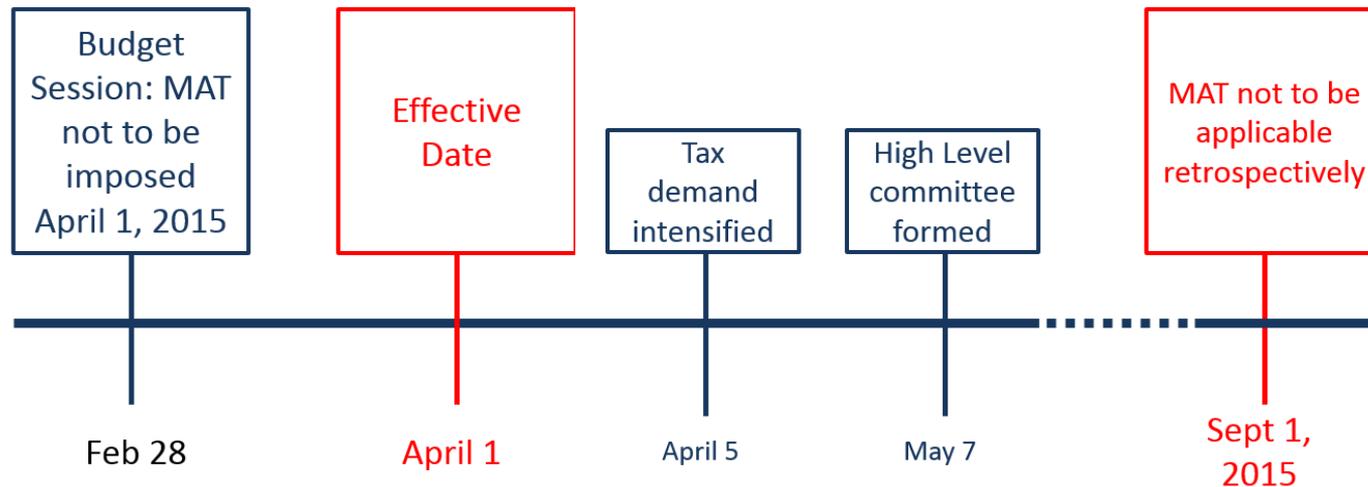
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OPINION | COMMENTARY

Tax Terrorism Returns to India

Narendra Modi's government needs to stop sending mixed messages about its taxation policy.

The Time-Line and the Question



- Test direction and size of the **reaction** of FPIs following MAT announcement.
- Investigate possible **implications** of MAT trading on stock characteristics.
- Examine the **response** (direction and size) of FPIs once government removes the tax threat.

Findings

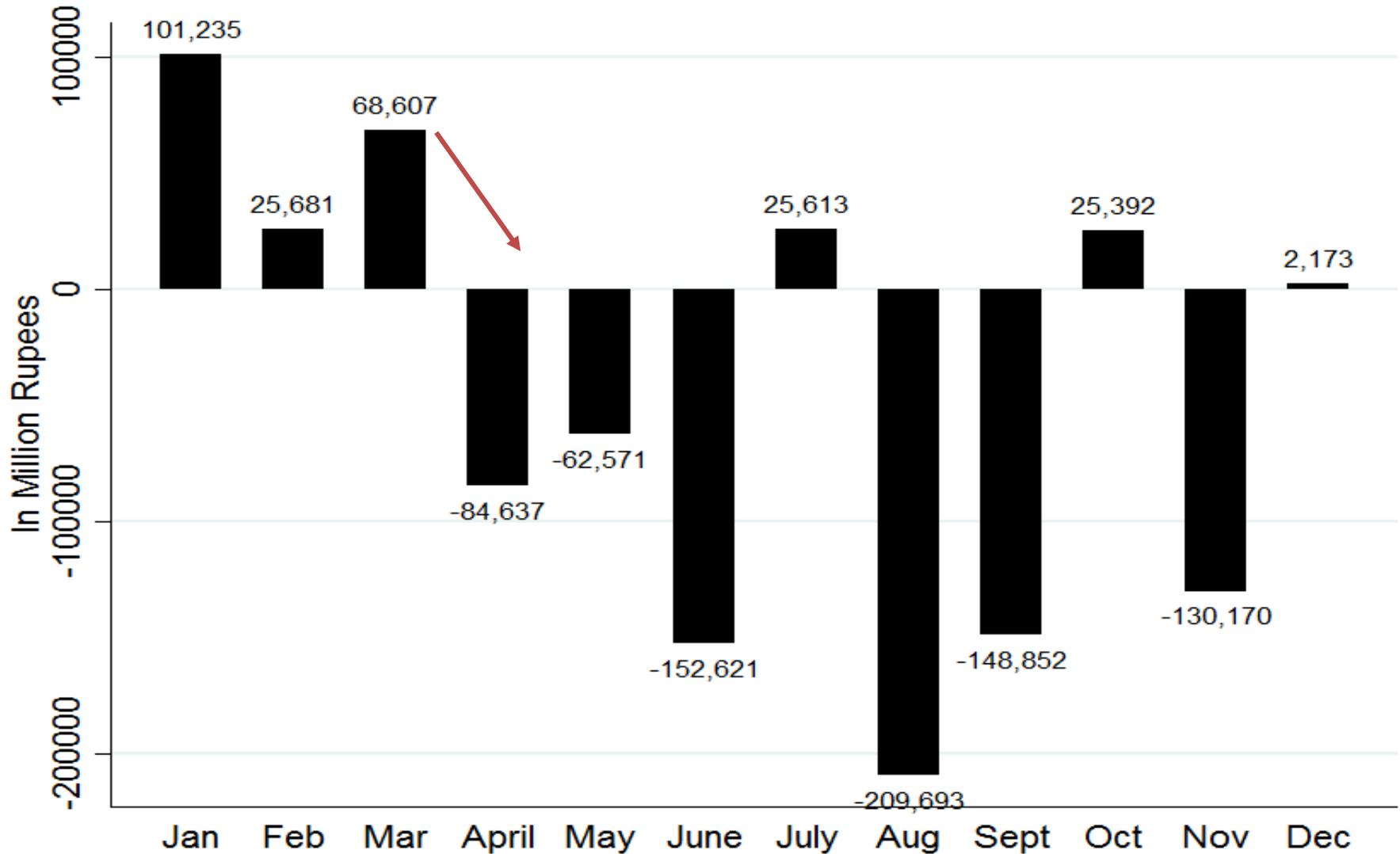
- **Significant market withdrawal** by FPIs following the effective date for MAT
- The outflow had **detrimental** bearing on the stock liquidity, stock volatility and the stock prices
- **No immediate and substantial inflows** once government removes the tax threat

Contributions

- FPIs' role in influencing policymaking in emerging markets, provide evidence of new channel i.e. market withdrawal response.
- Tax avoidance and FPI in emerging markets, examining the magnitude of FPIs sensitivity to tax policies.
- Whether tax subsidies are important for FPIs.
- Methodological contribution - exogenous shock
- To the conflicting literature on the destabilizing effect of FPIs' trading in emerging market

Summary Figures

Month-wise total net equity trading in 2015 (Million Rupees)



Effect of MAT Threat –DiD Results



- **Difference-in-differences (DiD)** method to establish causality
- Net equity trading by FPI for each sector from 1st Jan. 2003 to 31st Mar. 2015
- **Top 33%** of the sectors that have highest value of exposure as the treated group and **bottom 33%** of the sectors as the control group.

	Pre-MAT Threat Period	Post-MAT Threat Period	Difference	t-stat
Treatment Group	0.2322	-0.0484	-0.2807	-13.169
Control Group	0.1815	0.1030	-0.0785	-1.233
Difference (Pre-MAT)	0.0507			1.019
Difference (Post-MAT)		-0.1514		-3.879
Difference-in-Differences			-0.2022	-3.810

-0.2022

4.76 Million

Results – DiD regression

	Specification I	Specification II	Specification III	Specification IV
<i>MAT effect_t × TRMT</i>	-0.360*** (-5.72)	-0.364*** (-5.88)	-0.338*** (-5.12)	-0.309*** (-4.55)
Stock Return		0.100*** (13.28)	0.101*** (12.42)	0.102*** (11.96)
Market Return			0.0378 (1.25)	-0.000102 (-0.00)
Market Volatility			-0.789** (-2.39)	-0.712** (-2.46)
USD Volatility			-3.271 (-1.52)	-5.269** (-2.16)
Real GDP Growth Rate			0.0105 (0.92)	0.00530 (0.43)
EM Return				0.416* (1.86)
World Return				-0.304 (-0.46)
US TB Rate				-2.552*** (-3.00)
EM VIX Return				0.00648 (1.43)
Global VIX Return				-0.00728 (-1.39)
Firms Fixed Effects	Yes	Yes	Yes	Yes
Time (day) Fixed Effects	Yes	Yes	Yes	Yes
Sector Fixed Effects	Yes	Yes	Yes	Yes
Adjusted R ²	0.121	0.126	0.127	0.128
Number of Firms	863	861	855	855
Number of Observations	98,757	98,752	96,614	96,614

7.27 Million

Implication of FPIs' Withdrawal

	Turnover Ratio	Illiquidity Index	Liquidity Index
	Specification I	Specification II	Specification III
$MAT\ effect_t \times TRMT_i \times NET_{it}$	0.0086*** (2.72)	-0.0293** (-2.04)	-1.861** (-2.29)
Volatility	-0.585*** (-6.13)	0.662*** (6.78)	22.58*** (7.77)
Price	-0.0937** (-2.28)	0.303*** (8.75)	14.48*** (7.32)
Trades	0.208*** (8.22)	-0.268*** (-18.96)	-12.53*** (-22.51)
Market capitalization	0.237*** (5.59)	-0.242*** (-6.78)	-8.373*** (-9.73)
Absolute return	-0.00740*** (-4.41)	0.167*** (10.70)	0.809*** (16.32)
Firm Fixed Effects	Yes	Yes	Yes
Time (day) Fixed Effects	Yes	Yes	Yes
Sector Fixed Effects	Yes	Yes	Yes
Adjusted R ²	0.387	0.614	0.616
Number of Firms	779	779	779
Number of Observations	82,693	82,693	82,693

Implication of FPI Withdrawal

Stock volatility

	Specification I
$MAT\ effect_t \times TRMT_i \times NET_{it}$	-0.042* (-1.73)
Volatility	0.0965** (2.49)
Turnover Ratio	0.130*** (3.79)
Market Capitalization	-0.0784 (-1.42)
Price to Book Ratio	0.025 (1.27)
Illiquidity Index	116.3 (1.61)
Firm Fixed Effects	Yes
Time (day) Fixed Effects	Yes
Sector Fixed Effects	Yes
Adjusted R ²	0.175
Number of Firms	753
Number of Observations	81,580

Pricing effects of FPI Withdrawal Long Strategy on Treated Firms

	One Trading Day	Five Trading Days	Ten Trading Days	15 Trading Days	22 Trading Days
$MAT\ effect_t \times NET_{it}$	0.184*** (12.78)	0.0263*** (5.13)	0.00577*** (2.95)	0.000190 (0.10)	-0.00161 (-0.95)
Stock Return	0.0369 (1.49)	-0.00807 (-0.80)	-0.0109 (-1.55)	-0.0120** (-2.09)	-0.00463 (-1.09)
Market Capitalization	-0.236*** (-3.09)	-0.233*** (-4.15)	-0.194*** (-3.85)	-0.207*** (-4.12)	-0.203*** (-4.88)
Price-to-Book ratio	-0.264*** (-4.62)	-0.228*** (-5.64)	-0.207*** (-7.27)	-0.209*** (-7.23)	-0.196*** (-7.27)
Turnover Ratio	-0.00118 (-0.79)	-0.00144 (-1.32)	-0.00150* (-1.78)	-0.000648 (-0.77)	-0.0000397 (-0.05)
Volatility	-0.176 (-1.58)	-0.150** (-2.35)	-0.0683 (-1.44)	-0.0946** (-2.38)	-0.0609* (-1.90)
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes
Time (Day) Fixed Effects	Yes	Yes	Yes	Yes	Yes
Adjusted R ²	0.100	0.132	0.176	0.222	0.253
Number of Firms	532	528	500	511	519
Number of Observations	61,876	58,832	50,332	51,612	53,847

Pricing effects of FPI Withdrawal Short Strategy on Control Firms

	One Trading Day	Five Trading Days	Ten Trading Days	15 Trading Days	22 Trading Days
$MAT\ effect_t \times NET_{it}$	-0.224*** (-5.83)	-0.0419*** (-2.81)	-0.00201 (-0.20)	-0.00236 (-0.32)	-0.00322 (-0.58)
Stock Return	-0.0528 (-1.69)	-0.00918 (-0.73)	0.0129 (1.45)	0.00776 (1.06)	0.00505 (1.07)
Market Capitalization	0.878** (2.71)	0.684*** (3.24)	0.707*** (3.12)	0.633*** (3.22)	0.520*** (3.07)
Price-to-Book ratio	0.246** (2.46)	0.236** (2.59)	0.302*** (5.56)	0.226*** (3.27)	0.148* (1.99)
Turnover Ratio	0.153 (0.61)	0.0988 (0.96)	-0.0409 (-0.55)	-0.00995 (-0.17)	0.0184 (0.27)
Volatility	-0.533 (-0.79)	0.0646 (0.24)	0.00565 (0.03)	-0.0676 (-0.51)	0.145 (1.24)
Firm Fixed Effects	Yes	Yes	Yes	Yes	Yes
Time (Day) Fixed Effects	Yes	Yes	Yes	Yes	Yes
Adjusted R ²	0.105	0.118	0.154	0.184	0.191
Number of Firms	100	100	98	100	99
Number of Observations	9,904	9,422	8,075	8,210	8,533

FPIs' Market Re-entry: DiD Results

	Specification I	Specification II
<i>MAT reversal effect_t</i>	0.0398 (0.31)	
<i>MAT reversal effect_t × TRMT_t</i>		0.0476 (0.37)
Stock Return	0.0958*** (16.47)	0.0933*** (13.61)
Market Return	-0.00480 (-0.28)	0.00358 (0.18)
Market Volatility	-0.843*** (-3.52)	-0.585** (-2.29)
USD Volatility	-4.229** (-2.08)	-2.481 (-0.99)
Real GDP Growth Rate	0.00654 (0.62)	0.000681 (0.06)
EM Return	-0.0161 (-0.06)	-0.0700 (-0.26)
World Return	0.00412 (0.01)	0.145 (0.29)
US TB Rate	-1.268*** (-3.52)	-0.877** (-2.37)
EM VIX Return	-0.00871* (-1.78)	-0.0106** (-2.11)
Global VIX Return	-0.000391 (-0.09)	0.00176 (0.35)
Firm Fixed Effects	Yes	Yes
Time (day) Fixed Effects	Yes	Yes
Sector Fixed Effects	Yes	Yes
Adjusted R ²	0.117	0.113
Number of Firms	1070	883
Number of Observations	127,440	107,908

Conclusion

- Significant market withdrawal as a response to tax threat
- Disruptive impact of withdrawal on stock liquidity, volatility and prices
- Elimination of threat does not lead to immediate and materially substantive inflows
- Suggest that when changes in policy of the host government are detrimental to FPIs future prospects they could directly **influence policy changes** by their market power
- Tax advantage is important attraction for FPIs and policy-makers should take due care in formulating, announcing and implementing policies that could effect the expected payoff of FPIs

THANK YOU FOR YOUR TIME



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