

Taxation of Derivatives Trading in India: Policy Rationale, Revenue Outcomes, and Implications for Market Efficiency.

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Abstract

The rapid expansion of derivatives trading in India has transformed the structure of financial markets, with futures and options (F&O) emerging as dominant instruments of trading activity. This study examines the taxation of derivatives trading in India, focusing on its policy rationale, revenue implications, and impact on market efficiency. The research adopts a descriptive and analytical approach using secondary data from regulatory bodies, government reports, and academic literature covering the period from 2015 to 2026.

The findings indicate that the growth of derivatives trading has significantly contributed to government revenue, particularly through the Securities Transaction Tax (STT). However, the increasing reliance on transaction-based taxation raises concerns regarding its impact on trading behaviour, liquidity, and price discovery. The study also highlights that higher transaction costs disproportionately affect retail investors, who form a substantial portion of market participants and often incur significant losses.

Further analysis reveals a trade-off between tax rates and market activity, where excessive taxation may reduce trading volumes and limit revenue potential in the long run. In comparison with global markets, India's taxation framework appears relatively restrictive, potentially affecting market competitiveness. The study concludes that a balanced approach, integrating taxation with regulatory measures and investor awareness, is essential for ensuring sustainable and efficient market development.

Keywords: Derivatives Trading, Securities Transaction Tax, Market Efficiency, Tax Policy, Retail Investors, Financial Markets, India

1. Introduction

Over the past decade, the Indian financial market has undergone a significant structural transformation, particularly with the rapid expansion of derivatives trading. Initially introduced as instruments for hedging and risk management, derivatives (especially futures and options) have evolved into the dominant segment of trading activity in India. This growth is evident in the substantial increase in trading volumes, positioning India as one of the largest derivatives markets globally (FIA, 2026).

A defining characteristic of this transformation is the disproportionate dominance of derivatives over the cash segment. Empirical evidence suggests that a large share of equity market turnover in India is concentrated in derivatives trading, while the cash market contributes a comparatively smaller portion (FIA, 2026). This imbalance reflects a broader shift in market behaviour from long-term investment to short-term, high-frequency trading and speculative activity. The introduction of weekly expiry contracts, advancements in digital trading infrastructure, and the accessibility provided by low-cost brokerage platforms have further accelerated this trend.

Another important dimension of this expansion is the sharp increase in retail investor participation. The number of trading accounts has grown exponentially, and retail investors now constitute a significant share of derivatives trading volumes (CFA Institute, 2025). However, this surge in participation has raised serious concerns regarding investor protection and financial literacy. Empirical studies indicate that a large majority of retail participants incur consistent losses in derivatives trading, highlighting the speculative nature and inherent risks associated with such instruments (SEBI, 2024).

In response to these developments, taxation has emerged as a key policy tool in regulating derivatives markets in India. The Securities Transaction Tax (STT), introduced under the Finance Act, 2004, is levied on transactions executed on recognised stock exchanges. Unlike conventional income taxation, STT is imposed on the value of transactions irrespective of profitability, thereby directly increasing trading costs (Government of India, 2004). In addition, income derived from derivatives trading is classified as non-speculative business income under the Income Tax Act, making it subject to applicable income tax rates (Income Tax Act, 1961).

Recent policy measures, particularly revisions in STT rates through successive Union Budgets, reflect the government's attempt to balance revenue generation with market regulation. The increase in transaction taxes on derivatives trading indicates a deliberate effort to curb excessive speculative activity, especially among retail investors, while ensuring a stable source of revenue for the government (Ministry of Finance, 2026). However, such measures also raise important questions regarding their broader implications for market efficiency, liquidity, and price discovery.

The central issue, therefore, lies in the trade-off between regulatory objectives and market performance. While higher transaction taxes may discourage speculative trading and enhance tax revenues, they can also increase transaction costs, reduce trading volumes, and potentially impair market efficiency. Furthermore, in a globally integrated financial environment, differences in taxation across jurisdictions may influence capital flows and the competitiveness of domestic markets (Matheson, 2011).

Against this backdrop, the present study examines the taxation of derivatives trading in India, focusing on its policy rationale, revenue outcomes, and implications for market efficiency. The study aims to analyse the effectiveness of taxation measures, particularly the Securities Transaction Tax, in achieving their intended objectives without adversely affecting the functioning of financial markets.

The significance of this study lies in its relevance to ongoing policy debates on financial market regulation in India. By integrating empirical evidence, policy analysis, and comparative perspectives, the research seeks to contribute to a deeper understanding of the role of taxation in shaping derivatives markets and its broader economic implications.

2. Literature Review

The rapid expansion of derivatives trading in India has attracted significant academic attention, particularly in relation to taxation, market efficiency, and investor behaviour. Existing literature highlights the complex interplay between transaction taxes, trading activity, and financial market stability.

A major strand of research examines the impact of transaction taxes, such as the Securities Transaction Tax (STT), on market liquidity and efficiency. Studies have consistently found that higher transaction costs tend to reduce trading volumes and widen bid-ask spreads, thereby affecting market quality (Matheson, 2011). Empirical evidence from international markets suggests that transaction taxes often lead to a decline in liquidity without significantly reducing volatility, indicating limited effectiveness in stabilising markets (Capelle-Blancard & Havrylychuk, 2016). Similar conclusions have been drawn in emerging market contexts, where trading volumes exhibit high sensitivity to transaction costs (Baltagi et al., 2006).

In the Indian context, several studies have explored the implications of STT on derivatives markets. Agarwal and Jain (2022) find that increases in STT are associated with a moderate decline in trading volumes and a short-term increase in volatility. Similarly, Patel and Kaur (2023) observe that higher transaction taxes can impair liquidity by increasing trading costs, particularly for high-frequency and arbitrage strategies. Mishra et al. (2021) highlight that changes in transaction tax structures can alter the price discovery process, with derivatives markets becoming less efficient when trading costs rise.

Another important area of research focuses on retail investor participation in derivatives markets. The growing presence of retail traders has been widely documented, particularly after the COVID-19 pandemic. Studies indicate that while derivatives offer opportunities for portfolio diversification, retail investors often lack the expertise required to manage

associated risks (Bhope et al., 2024). Empirical findings from regulatory analyses show that a significant proportion of retail traders incur losses, largely due to behavioural biases and speculative trading patterns (SEBI, 2024). Sharma (2021) further notes that retail participation is highly sensitive to transaction costs, with increases in STT leading to a temporary decline in retail trading activity.

Research also highlights the differential impact of taxation on retail and institutional participants. Tripathi and Menon (2025) find that retail traders are more adversely affected by transaction taxes compared to institutional investors, who can employ hedging strategies to mitigate costs. Singh and Chandana (2025) argue that higher transaction costs may encourage a shift towards riskier trading strategies, as traders attempt to offset the increased tax burden through higher returns. This suggests that taxation may not always achieve its intended objective of reducing speculative behaviour.

From a policy perspective, studies emphasise the trade-off between revenue generation and market development. Menon and Verma (2022) demonstrate that while transaction taxes can generate substantial government revenue, excessive taxation may reduce the overall tax base by discouraging trading activity. Das and Rao (2021) highlight the risk of regulatory arbitrage, where higher domestic taxes may drive trading activity to offshore or unregulated markets. This concern is particularly relevant in the context of increasing global integration of financial markets.

Comparative studies further reveal that India's taxation framework for derivatives differs significantly from global practices. Choudhary (2023) notes that major financial markets such as the United States, the United Kingdom, and Singapore do not impose transaction taxes on derivatives, instead relying on income or capital gains taxation. This difference raises concerns regarding the competitiveness of Indian markets in attracting global capital.

Overall, the literature suggests that while transaction taxes like STT can serve as effective tools for revenue generation, their impact on market efficiency and investor behaviour remains mixed. The evidence indicates a need for a balanced approach that considers both regulatory objectives and market development.

3. Methodology

The present study adopts a descriptive and analytical research design to examine the taxation of derivatives trading in India, with specific focus on policy rationale, revenue outcomes, and implications for market efficiency. The research is primarily based on secondary data, as the study aims to analyse macro-level trends, policy changes, and market behaviour rather than individual perceptions or survey-based responses. Secondary data has been collected from reliable and authoritative sources, including reports published by the Securities and Exchange Board of India (SEBI), National Stock Exchange (NSE), Ministry of Finance, and other government publications such as Union Budget documents. In addition, academic research papers, working papers, and reports from international organisations have been reviewed to support theoretical and empirical analysis.

The study covers the period from approximately 2015 to 2026, capturing both the rapid expansion phase of the Indian derivatives market and the recent policy interventions related to taxation, particularly changes in the Securities Transaction Tax (STT). This time frame enables a comprehensive analysis of long-term trends as well as recent developments in taxation policy and their effects on trading behaviour and market outcomes.

The analytical framework of the study is structured around three key dimensions: taxation structure, market behaviour, and revenue implications. The taxation structure is examined by analysing the design and evolution of STT rates on derivatives, along with the income tax treatment of derivatives trading under the Income Tax Act. Market behaviour is assessed through indicators such as trading volumes, retail participation, and changes in trading strategies, while revenue implications are evaluated based on trends in STT collections and their contribution to overall tax revenue.

To strengthen the analytical component, the study incorporates scenario-based analysis and simulation techniques. These simulations are used to examine the relationship between transaction tax rates, trading volumes, and government revenue. By applying different assumptions regarding elasticity of trading volume with respect to transaction costs, the study estimates potential outcomes under varying tax regimes. This approach helps in understanding the trade-offs between higher tax rates and possible reductions in trading activity, thereby providing insights into the effectiveness of taxation as a policy instrument.

In addition to quantitative analysis, the study adopts a comparative approach by examining taxation frameworks for derivatives trading in selected international markets such as the United States, the United Kingdom, and Singapore. This comparison provides a broader perspective on how different tax structures influence market development and efficiency, and helps identify potential gaps in the Indian taxation framework.

The study is subject to certain limitations. As it relies primarily on secondary data, the analysis is dependent on the accuracy and availability of published information. Additionally, while scenario-based simulations provide useful insights, they are based on assumed relationships and may not fully capture real-world complexities. Despite these limitations, the methodology provides a robust framework for analysing the impact of taxation on derivatives trading in India.

4. Analysis and Results

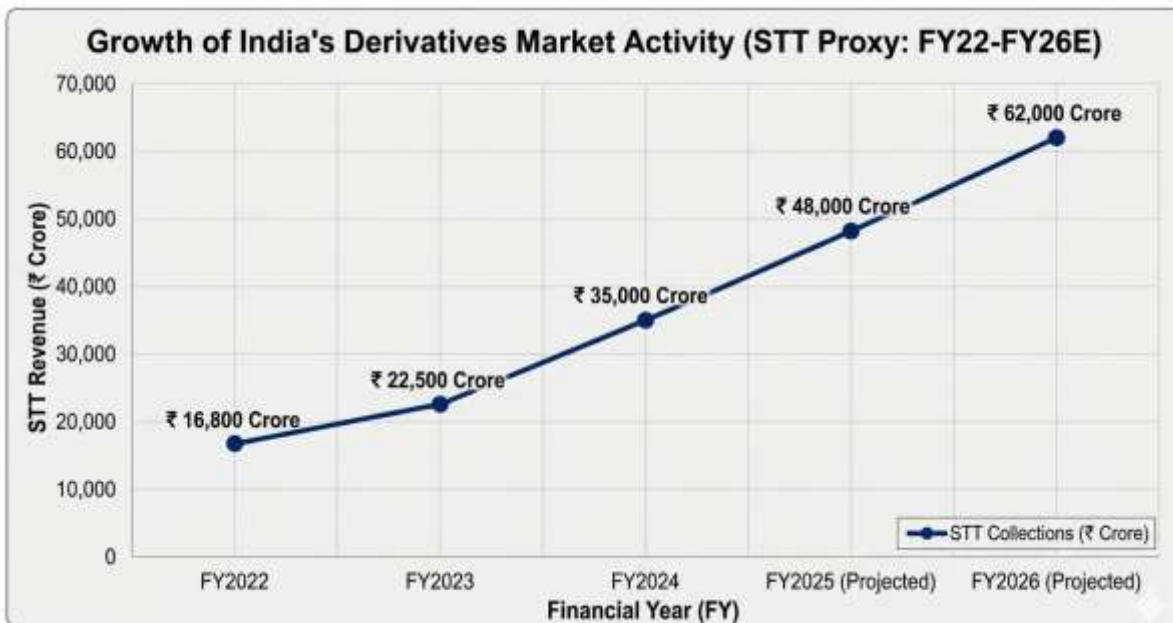
Growth of the Derivatives Market in India

The Indian derivatives market has witnessed exponential growth over the past decade, driven by increased retail participation, technological advancements, and the introduction of weekly options contracts. India has emerged as one of the largest derivatives markets globally in terms of trading volume, with a significant concentration of activity in index options (FIA, 2026).

A key characteristic of this growth is the dominance of derivatives over the cash segment. Estimates indicate that derivatives account for a substantial proportion of total trading activity, reflecting a structural shift in market behaviour toward short-term trading and speculation (CFA Institute, 2025).

This expansion has been accompanied by a sharp increase in retail participation. However, empirical evidence suggests that a large majority of retail traders incur losses in derivatives trading, raising concerns regarding market sustainability and investor protection (SEBI, 2024). The growth of derivatives trading in India can be further illustrated through trends in Securities Transaction Tax (STT) collections, which serve as a proxy for market activity.

Figure 1: Growth in Derivatives Trading Activity in India (FY2022–FY2026)



Source: Ministry of Finance (2026), SEBI (2024), NSE data

The figure demonstrates a significant upward trend in STT collections over the observed period, reflecting the rapid expansion of derivatives trading activity in India. The sharp increase in recent years indicates heightened market participation and trading intensity, particularly driven by retail investors. This trend highlights the growing financialization of the Indian equity market and underscores the increasing importance of derivatives as a major contributor to both market activity and government revenue.

Taxation Structure and Recent Policy Changes

The taxation of derivatives trading in India primarily operates through the Securities Transaction Tax (STT) and income tax provisions. STT is levied on transactions executed on recognised stock exchanges, irrespective of profitability, thereby directly increasing trading costs (Government of India, 2004).

Recent changes introduced through the Union Budget 2026 have significantly increased STT rates on derivatives:

Table 1: STT Rate Changes on Derivatives

Instrument	Previous Rate	Revised Rate (2026)	Change
Equity Futures (Sell)	0.02%	0.05%	+150%
Options Premium (Sell)	0.10%	0.15%	+50%
Options Exercise	0.125%	0.15%	+20%

Source: Ministry of Finance (2026)

These changes reflect a policy shift aimed at increasing revenue while discouraging excessive speculative trading.

Revenue Trends from STT

STT has become a significant source of government revenue, particularly with the growth of derivatives trading.

Table 2: STT Revenue Trends

Financial Year	STT Collection (₹ Crore)
FY2022	~23,000
FY2023	~25,000
FY2024	~33,000
FY2025	~53,095
FY2026 (Target)	~63,670

Source: Ministry of Finance (2026)

The data indicates a strong upward trend in STT collections, driven by increased trading volumes. However, the sustainability of this growth depends on how trading activity responds to higher tax rates.

Impact of Taxation on Trading Volume and Market Behaviour

The increase in STT rates has direct implications for trading costs, particularly for high-frequency traders and retail participants. Higher transaction costs can reduce trading volumes, especially for strategies that rely on small margins.

Empirical observations suggest that regulatory measures and higher taxes have led to a short-term decline in trading volumes. At the same time, the market has shown resilience, indicating that underlying participation remains strong (SEBI, 2025).

Retail behaviour has also been affected. While higher taxes may discourage excessive trading, they may also lead to unintended consequences such as increased risk-taking, as traders attempt to offset higher costs through larger positions or more aggressive strategies.

Scenario-Based Analysis: STT, Volume, and Revenue

To understand the trade-off between tax rates and revenue, scenario-based analysis is conducted using different assumptions regarding trading volume response.

Table 3: Scenario Analysis of STT Impact

Scenario	STT Rate	Volume Change	Estimated Revenue Impact
Base Case	0.02%	No change	Baseline
Moderate Increase	0.05%	-30%	Revenue increases
High Impact	0.05%	-50%	Limited revenue gain
Extreme Case	0.05%	-70%	Revenue declines

Source: Researchers' Assumed Scenarios

The analysis suggests that while higher tax rates can increase revenue in the short term, excessive taxation may reduce the tax base by significantly lowering trading volumes. This highlights the importance of balancing tax rates with market activity.

International Comparison

A comparison with global markets reveals significant differences in taxation frameworks.

Table 4: Comparison of Derivatives Taxation

Country	Transaction Tax	Income Tax Treatment
India	STT (0.05% - 0.15%)	Business income (up to ~39%)
USA	No STT	Capital gains (60/40 rule)
UK	No STT on derivatives	Capital gains tax

Singapore	No STT	Generally no capital gains tax
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Source: Ministry of Finance (2026), Internal Revenue Code (USA), HM Revenue & Customs (UK), Inland Revenue Authority of Singapore (IRAS)

India's reliance on transaction-based taxation contrasts with global practices, where taxation is typically based on realised gains rather than transaction value. This difference has implications for market competitiveness and liquidity.

Key Findings

The analysis of derivatives taxation in India reveals a complex interaction between market growth, regulatory intervention, and fiscal objectives. One of the most significant findings is the rapid expansion of the derivatives segment, which has increasingly dominated the overall trading activity in Indian equity markets. This structural shift indicates a transition from traditional investment-driven markets toward trading environments characterised by short-term speculation and high turnover. While such growth reflects increasing market participation and financialization, it also raises concerns regarding the sustainability and efficiency of capital allocation.

Another important finding relates to the growing importance of the Securities Transaction Tax (STT) as a source of government revenue. The consistent rise in STT collections highlights the extent to which financial market activity contributes to the fiscal framework.

However, this also indicates a degree of dependence on transaction-based taxation, which is inherently sensitive to market volumes. The reliance on STT introduces a potential vulnerability, as any significant decline in trading activity could adversely impact revenue generation.

The analysis further shows that increases in transaction taxes directly influence trading behaviour by raising the cost of participation. Higher STT rates tend to reduce the attractiveness of high-frequency and low-margin trading strategies, leading to a contraction in trading volumes, particularly in the short term. At the same time, the persistence of trading activity despite higher costs suggests that the underlying demand for derivatives remains strong. This indicates that while taxation can moderate excessive trading, it may not fundamentally alter market participation patterns.

A critical insight emerging from the study is the disproportionate impact of taxation on retail investors. Unlike institutional participants, who often employ hedging strategies and have greater financial capacity, retail traders are more sensitive to transaction costs. The increase in trading costs may discourage some retail participation. However, it may also lead to unintended behavioural changes, such as increased risk-taking in an attempt to offset higher costs. This highlights the limitations of taxation as a tool for regulating investor behaviour.

The scenario-based analysis reinforces the existence of a trade-off between tax rates and market activity. While higher STT rates can increase revenue under moderate volume declines, excessive taxation may reduce the overall tax base by significantly lowering trading volumes. This suggests that there exists an optimal level of taxation beyond which the marginal benefit in terms of revenue diminishes. The findings are consistent with theoretical perspectives on the relationship between taxation and economic activity, particularly in the context of highly elastic financial markets.

Finally, the international comparison highlights that India's taxation framework differs significantly from global practices, where derivatives trading is typically not subject to transaction-based taxes.

Instead, most developed markets rely on income or capital gains taxation. This divergence raises important questions regarding the global competitiveness of Indian financial markets, particularly in attracting institutional capital and maintaining liquidity.

Overall, the findings suggest that while taxation serves as an effective tool for revenue generation and partial regulation of speculative activity, its impact on market efficiency and investor behaviour is nuanced. A balanced approach is therefore required to ensure that policy objectives are achieved without adversely affecting market development.

5. Discussion

The findings of the study highlight the complex relationship between taxation policy and the functioning of derivatives markets in India. The rapid expansion of derivatives trading, as evidenced by increasing trading volumes and rising STT collections, reflects a broader trend of financialization within the Indian economy. However, this growth has been accompanied by structural imbalances, particularly the dominance of derivatives over the cash segment and the increasing participation of retail investors in high-risk trading activities.

One of the central issues identified in this study is the dual role of taxation as both a revenue-generating mechanism and a regulatory tool. The increase in Securities Transaction Tax (STT) rates demonstrates the government's attempt to address concerns related to excessive speculation while simultaneously strengthening fiscal revenues. In the short term, the rise in STT collections suggests that the policy has been effective in enhancing government revenue. However, the long-term implications of such an approach remain uncertain, particularly in light of the sensitivity of trading volumes to transaction costs.

The analysis indicates that higher transaction taxes can influence market behaviour by increasing the cost of trading. This is particularly relevant for high-frequency and low-margin trading strategies, which are more sensitive to incremental cost changes. While such measures may reduce excessive speculative activity, they may also lead to unintended consequences, including reduced liquidity and wider bid-ask spreads. These effects can, in turn, impact price discovery and overall market efficiency.

Another important aspect of the discussion is the differential impact of taxation on various market participants. Retail investors, who often lack sophisticated risk management strategies, are more adversely affected by increases in transaction costs.

The evidence suggesting that a majority of retail traders incur losses highlights the limitations of taxation as a tool for investor protection. Instead of discouraging participation, higher costs may lead some traders to adopt riskier strategies in an attempt to achieve higher returns, thereby increasing their exposure to potential losses.

The study also brings attention to the broader policy trade-offs associated with derivatives taxation. While higher STT rates contribute to increased revenue, excessive taxation may reduce the overall tax base by discouraging trading activity. This reflects the classical economic principle that beyond a certain threshold, higher tax rates may lead to diminishing returns in terms of revenue generation. In the context of highly elastic financial markets, this trade-off becomes particularly significant.

Furthermore, the international comparison underscores the uniqueness of India's taxation framework. Unlike major global markets such as the United States, the United Kingdom, and Singapore, which do not impose transaction taxes on derivatives, India relies significantly on STT as a source of revenue. This divergence raises concerns regarding the competitiveness of Indian financial markets, particularly in attracting institutional investors and maintaining liquidity in the long run.

From a policy perspective, the findings suggest that taxation alone may not be sufficient to address issues related to speculative trading and investor protection. A more balanced approach that combines taxation with regulatory measures, investor education, and market reforms may be more effective in achieving the desired outcomes. Additionally, periodic review of tax rates and their impact on market activity is essential to ensure that policy objectives are aligned with market development goals.

Overall, the discussion highlights the need for a nuanced approach to derivatives taxation in India. While taxation plays a crucial role in revenue generation and market regulation, its design and implementation must carefully consider its broader implications for market efficiency, investor behaviour, and long-term financial development.

6. Conclusion

Based on these findings, the study concludes that while taxation is an important policy tool, it must be carefully calibrated to balance revenue objectives with market development. A more comprehensive approach, combining taxation with regulatory oversight and investor awareness initiatives, is essential to ensure sustainable growth and efficiency in the derivatives market.

The analysis underscores that the effectiveness of taxation in financial markets depends not only on revenue outcomes but also on its broader impact on market behaviour and efficiency. In the Indian context, the increasing reliance on transaction-based taxation highlights the need for a more balanced and adaptive policy framework that can respond to changing market dynamics. Ensuring that taxation does not disproportionately burden certain categories of market participants, particularly retail investors, remains a key policy consideration.

Moreover, as global financial markets become increasingly integrated, the relative taxation structure may influence the competitiveness of domestic markets. Aligning tax policies with international practices, while maintaining regulatory objectives, is essential for sustaining market depth and attracting long-term participation.

Scope for Further Research:

Future research can focus on empirical assessment of the long-term impact of transaction taxes on market efficiency, liquidity, and volatility using granular market data. Comparative studies across different jurisdictions may provide insights into optimal taxation structures for derivatives markets. Additionally, further research may examine behavioural responses of retail investors to changes in taxation and evaluate the effectiveness of alternative regulatory and educational interventions in improving market outcomes.

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