

Chapter 8

REFORM OF CORPORATE TAXATION IN INDIA

Corporate tax, in a diversified expanding economy, constitutes an important source of revenue. It assumes greater importance owing to its revenue elasticity being high; with increase in industrial activity and consequent escalation in corporate incomes, the revenue yield to the exchequer records an increasing trend. The yield from corporation tax amounted to Rs.1377 crores in 1980-81, working out to 10.5 per cent of gross tax revenue in that year. While the budget estimates for 1990-91 incorporated corporation tax yield at Rs. 5335 crores, the corresponding figure for 1995-96 is Rs. 15500 crores. The respective shares amount to 9.3 per cent and 14.9 per cent of the gross tax revenue in the respective years. (Vide Tables 7.1 and 7.2) Thus, the yield from corporation tax has increased by about nine times over a period of about one and a half decades, reflecting the tremendous expansion that has taken place in industrial and other activities in the economy and corporate incomes, although a part of the increase is accounted for by the increase in price level.

Inflow of direct foreign investment has considerably increased and it is envisaged that with rationalization of the tax structure and accelerated industrial growth, including in the infrastructure sector, corporate tax revenues should record a quantum leap in the last few years of this century, and the Budget for 2000-1 may account for revenue from corporate taxation exceeding Rs.20000 crores.

The corporate tax structure has grown in a haphazard manner and taxes are high both by international standards and for promoting capital formation in a liberalized environment. It needs to be rationalized if it is to serve as an instrument of growth and is to fulfil certain social objectives as being attractive

for foreign capital (with high technology), growth of backward areas and diminution of regional imbalances.

8.1. Corporate Tax Reform

Corporate income tax in India is almost as ancient as income tax and vestiges of the former are traceable even in the 1860 Income-Tax Act. The 1922 Act, as amended in 1939, partly accepted the imputation principle in regard to corporation tax, which implies that a company pays income tax on behalf of its shareholders. Till the 1959-60 Budget, dividends received by shareholders were grossed up by 46 per cent in their hands, and the amount of grossing up was considered to be tax paid by the company for its shareholders, to be deducted from the latter's personal tax liability on total income (including the grossed up dividends).

The 1959-60 Budget adopted the classical scheme of taxation, according to which the company pays tax on its own account and the shareholder does not receive any credit for tax paid by the company. When the new scheme was introduced in 1959, grossing up of dividends was abolished and the corporation tax rate was reduced from 51.5 per cent to 45 per cent in the case of Indian companies. It was proposed that the overall tax rate applicable to Indian companies would be so fixed that the yield would be equal to the annual gross yield less the annual credit given to the shareholders. The tax liability of the shareholders would no longer be related to the tax borne by the companies.

The corporation tax structure and the rates during the last three decades have undergone several changes, but basically the classical system has continued to be operative. Before we analyse the corporate tax system in India, it is desirable to have an overview of modern analytical thinking in respect of the classical view and integrationist view of corporation tax, and the Meade Committee (UK)'s¹ (1978) recommendation for replacement of corporation tax by a tax on corporate cash flows.

J. A. Kay² (March 1990) argued that the income of companies is ultimately that of shareholders and ideally that income should be attributed to them and taxed accordingly. That is the integrationist view, but it has not been wholly accepted anywhere in the world. However, recent reforms in Australia and New Zealand have achieved to an extent integration between personal and corporate income taxes by providing for equivalent individual and corporate tax rate and a high degree of imputation. Complete integration of corporate and personal income taxes is more an academic concept than a practical proposition as (a) the company is a separate legal entity distinct from its shareholders and the latter have no claim or right upon the company's reserve until distributed or capitalized; (b) it is inequitable to include in the shareholder's income a portion of the company's retained profits which have not been received by him; (c) shareholders buy and sell shares in companies and the company's members' list is in a continuous state of flux (except during the period of book closing). A person who is a shareholder on the record date for distribution of dividend and ceases to be a member after a month may be taxed on an amount which he has neither received nor will ever receive.

The United States and India have adopted the classical scheme of company taxation; and there is complete dichotomy between the corporation tax on companies and income tax on individuals. In this system, dividends are taxed twice; once in the hands of the company as its income, and secondly as dividends to the extent of distribution in the hands of the shareholders (subject to partial tax exemption in respect of dividends). However, in the UK, France and Germany, corporate taxation is based on the system of partial imputation, according to which the shareholder receives credit for some part of the tax liability of corporations through grossing up of dividends.

Rationalization of the corporate tax structure constitutes an integral part of the package of liberalization policies, currently being implemented by the Government – which have been highly successful in certain respects. For a country

implementing and formulating liberalization policies with the avowed objective of accelerating the rate of development through, inter alia, inflow of foreign investment capital with sophisticated technology, it is imperative that the investment climate is conducive to such inflow. Some of the principal determinant factors are reasonable security of tenure and opportunities for building up an industrial complex over a period of years. The foreign investor would undertake investment only if he feels safe and a suitable environment exists for his obtaining a fair return on capital investment, commensurate with the risks involved. He would hardly risk his capital, if the future perspective for industry, economic or political, is gloomy or excessive state intervention and controls constrain growth. In this context, the present liberalization measures have been successful in dismantling the network of controls and regulations to a considerable extent; and increasing foreign investor interest is perceptible. Another important determinant in this regard is that the return on capital employed *net of taxes* is sufficiently attractive by international standards – since most developing countries in the world are vying with each other to stimulate the inflow of foreign investment – to induce foreigners to invest in India.

Corporate tax rates in India were out of alignment with the tax rates in developed countries like U.S.A., U.K. and other O E C D and East Asian countries. The Table 8.1 illustrates this point. Actually the trend the world over was towards simplification of the tax structure and lowering the levels of taxation. The effective rate of taxation in Germany was lower, as distributed profits of companies were taxed at a reduced rate. What should be the structural framework of policy in this regard for a developing country – whether profits ploughed back or profits distributed should be taxed at a lower rate – has been discussed in Section 7.3.

8.2. Impact of Fiscal Policy on Corporate Sector

The corporate tax structure and impact of fiscal policy thereon may be considered. The surcharge on corporate tax introduces an element of instability in the tax structure and should be withdrawn. While corporate taxation should

be reduced in order to induce greater tax compliance and check tax evasion, various tax exemptions and fiscal incentives provided to the corporate sector may be reviewed and reduced. While important incentives such as tax holiday for new companies, investment allowance for new investment, rebate for exports, backward areas development, scientific research and such other important incentives should be retained, others may be withdrawn. Modification of the corporate tax structure along these lines would stimulate investment and inflow of foreign investment capital. However, the Government has abolished investment allowance and certain other vital allowances as also the backward areas tax rebate.

Despite assurance of stability in tax structure, the framework of corporate taxation has been subjected to modifications almost every year. Besides, the surcharge on domestic companies with incomes above Rs. 75,000 amounts to 15 per cent. The effective tax rate for the assessment year 1994-95 works out to 46 per cent for both public companies and controlled companies. Thus distinction between public and private companies was abolished, which is commendable. Small companies with profits less than Rs.5 lakhs continue to be taxed at the same rate as large companies, thereby adversely affecting their capacity to plough back profits for expansion and to raise fresh capital. However, surcharge on corporate profits is not applicable to companies with profits below Rs.75,000. As such, in their case, the tax works out to 40 per cent.

It is significant that when the basic tax rate was reduced from 50 per cent to 40 per cent for the assessment year 1991-92 for public companies, investment allowance had been withdrawn. It was almost in the nature of a trade-off. But no such allowance was restored, even though corporate tax rates were increased. The basic corporate tax rate should be in the region of 30 to 35 per cent as in various developed and developing countries.

Table 8.1
Basic Corporation Tax Rates in Selected Countries. (1995)
(In per cent)

India	46
Japan	37.5
Philippines	35
South Korea	35
USA	35
France	34
Indonesia	34
Malaysia	34
UK	33
Sweden	32
Pakistan	30
Thailand	30
Singapore	27
Brazil	25
Taiwan	25
Hong Kong	17.5

Source : Worldwide Tax Guide, Pannell Kerr Forster, P K F Worldwide, Melbourne, various pages.

The proposed tax rates would bring the tax structure in closer alignment with the level of taxes prevailing in the U.K., where the maximum statutory corporation tax rate is 33 per cent and the U S A, where it is 35 per cent, and in other countries (Vide Table 8.1). Besides, Britain has the imputation system of taxation, whereby shareholders receive credit for part of the taxes paid by corporations. Except for exemption of dividends upto a small limit under section 80L, there is double taxation of incomes in India: in the hands of the company and again in the hands of shareholders. Take the case of intercorporate dividends. It was provided that inter-corporate dividends would be free of tax, provided the company distributes an equivalent amount by way of dividend paid. The objective is to encourage genuine investment activity, while discouraging the use of corporate framework for holding personal wealth. Actually, inter-corporate dividends should be tax-free.

A Reserve Bank study³ suggests that (a) it is more advantageous to have a low tax rate with a few well conceived concessions than to have a seemingly high rate with multifold concessions; (b) the average net rate of return was lower in India than in the U.K., U. S. A., France, Germany or Japan; (c) the contribution of depreciation to gross capital formation far exceeded that of retained profits; and (d) growth rates of companies depend upon various factors such as, *inter alia*, efficiency of capital utilization, technological upgradation and sound management. The conclusion is that besides rationalization of corporate tax structure, improvement in operational efficiency, modernization and induction of better technology are imperative if Indian industry is to remain internationally competitive and generate internal resources for accelerated growth.

8.3. Inflation and High Replacement Cost

Tax laws continue to tax corporate profits on the basis of historical cost accounts which provide for depreciation on the original cost of assets, without taking into account the impact of inflation on the replacement cost of fixed assets

and inventories.

Accounts prepared on the conventional basis of historical cost of assets and inventories, gave an increasingly misleading picture, since inflationary fires, fuelled by the staggering increase in the price of oil, had played havoc with the economies of non-oil exporting countries; and the continuing inflation had resulted in a multifold rise in the replacement cost of machinery. Historical cost accounts suffered from certain serious drawbacks: firstly, provision for depreciation was extremely inadequate resulting in showing excessive, even illusory, profits on which the company was taxed, thus depriving it of funds required over the years to maintain its assets in good form and condition. Secondly, in the planning of company's operation and growth, management was deprived of true facts and figures on which such planning should be based.

Peter Drucker's⁴ views in this context, are highly relevant. He states that inflation destroys assets. 'It creates spurious profits, which in effect represent destruction of capital.' Since depreciation is based on yesterday's currency value, it is inadequate as currency is shrinking in value; and when replacement of assets becomes necessary – which is inevitable – 'the costs in depreciated currency will be many times greater than the book value.' If this is not recognised, profits shown in the accounts are unreal and dividends will be paid, which in effect amount to distribution of capital.

Take the instance of investment by American companies in Latin American countries. the Securities and Exchange Commission (S E C) in the U S A rendered it obligatory for companies to provide for the hidden loss, representing the depreciation in real terms of the asset value of such investments in say a subsidiary in Brazil, but the U.S. tax authorities would not allow this loss as deduction, and continued to tax the company on unreal profits, while the company, in pursuance of S E C's directive, may be showing a loss.

It has been calculated that an elite chemicals company in India over a

period of six years, was just able to cover depreciation on replacement cost basis, and in the process, its reserves dwindled to below Rs. 1 crore, as compared to the historical cost reserves of Rs.86 crores. If the share premium of Rs.22 crores was excluded from reserves, there would be a negative balance of more than Rs.20 crores in reserves and surplus in current cost accounts. This bears evidence that a leading corporation has not been able to provide depreciation adequately on replacement cost basis out of after-tax profits. Taxes have been paid on book profits, which in real terms did not exist.

8.4. Taxes on Cash Flow Mooted

Suggestion has been made by the Meade Committee (U.K.)⁵ (1978) for tax reform in Great Britain to include the replacement of corporation tax by a tax on corporate cash flow, which would imply that all capital investment would be allowed as a deduction from profits in the year in which the acquisition of plant, machinery and other assets takes place.

The corporation's inflow of cash consists of sale of goods and disinvestment of assets, in addition to interest and dividends. The outflow of cash comprises production costs and capital expenditure on purchase of plant, machinery and other assets, including interest payments on borrowings. The cash flow corporation tax has as its base the excess inflow over the outflow of cash. Thus all capital expenditure on fixed assets would be fully deductible, while sales of assets would be taxed in full.

A corporation tax on cash flow has several advantages. The need for indexation for inflation is eliminated as capital expenditure is immediately allowable for tax deduction. The distinction between capital and revenue loses its significance. The capital gains tax at a concessional rate as at present would no longer be necessary since the entire proceeds of sale of assets would be includible in the taxable inflows.

Though a cash flow corporation tax in India may initially reduce government revenue, the advantages should outweigh the losses. It would serve as a powerful incentive for industrial growth and enable modernization of machinery out of self-generated funds, thereby greatly reducing the malady of industrial sickness. A diminution in utilization of institutional funds would be accompanied by an increase in the volume of promoter's contribution, leading to greater cost consciousness and restraint in dividends. If it is not considered feasible to adopt a cash flow corporation tax, what the Government can do is to allow capital expenditure in approved assets in priority industries to be fully deducted for tax purposes (disinvestment being taxable). Such a measure would boost capital formation. As a sequel to stimulated production and income, government revenue would also escalate.

Section 80 I A provided for deduction of 25 per cent of profits from taxable income for eight years for new industrial undertakings (other than non-priority industries). The Government extended the deduction to 30 per cent of profits for companies for a period of ten years effective from April 1990. The 10 year partial tax holiday for new enterprises has been withdrawn in the 1995-96 Budget except for small-scale enterprises and industries established in backward areas. It is unfortunate that the backward areas development allowance has also been withdrawn. It would adversely affect the development of backward districts. Actually the rebate should have been extended to expenditure for infrastructural development in backward regions by companies. If a company spends money on development of roads, railway sidings, trucks, housing, provision for water and electricity, the capital expenditure should be eligible for such allowance at 15 per cent of the investment.

8.5. Merger and Set-off of Losses of Sick Companies

It would be readily appreciated that one of the best methods for rehabilitation of sick industrial units is to merge them with healthy companies. Section 72A

of Income Tax Act provides that in case of amalgamation of a company, the brought forward depreciation and losses of the amalgamating company would be allowed to be set off against the profits of the amalgamated company, if the sanction of the specified authority is obtained. The procedure for obtaining the sanction was cumbersome and time-consuming, and it discouraged mergers. According to the new Sick Industries Regulations, such amalgamation can be sanctioned by the B I F R. It is suggested that Section 72A should be amended to provide that in the case of such merger, the brought forward depreciation and losses of the merging company would be allowed to be set off against the profits of the healthy company, provided both are industrial companies without the need for any sanction. This would remove a prime constraint in regard to rehabilitation of sick units. The number of sick units in the country is so large, that it is not possible for the B I F R to deal with the large number of cases of small and medium sick units. This change in income tax law would provide an inbuilt device for the rehabilitation of sick units, and contribute to the resolution of this intractable problem.

The Government deserved kudos for exempting export profits of corporations (as also individuals) from tax. This not only acts as a stimulus for exports, but also has been instrumental in the establishment of several export oriented industrial complexes. Many large companies have been exporting a good portion of their products, which buttresses the country's export earnings.

Increase in productivity is necessary to improve corporate profitability on a micro basis, as also reduce the capital output ratio in the economy on a macro basis. A vital incentive to eventuate better utilization of plant and machinery and other factors is to provide excise duty rebate on production achieved over and above the previous year's output or in excess of certain norms of production established for various industries on the basis of empirical studies.

Economic growth in developing countries postulates capital formation on

a sizeable scale. Nucleus capital for new industrial corporations, as also expansion, is increasingly being provided by corporations. It is therefore imperative that the incremental corporate savings ratio, that is the ratio of savings or profits transferred for being ploughed back into business to the total profits after tax is maximized. In order to provide an incentive for corporate management to plough back profits for expansion and modernization, the tax on undistributed profits should be lower than the tax on distributed profits.

The Government abolished investment allowance as a measure of rationalization on the plea that it encouraged investment in capital intensive industries and over-investment in capital equipment. The Eighth Plan has assigned a significantly larger role to the private sector and as a sequel to modified policy decisions, it is being permitted to set up oil refineries, gas-based fertilizer plants, electronic, telecommunication, power generation and iron and steel plants. These are largely capital intensive industries, incorporating modern sophisticated technology. The withdrawal of investment allowance, which has catalytic effect upon industrial expansion, at this juncture, would be counter-productive. Investment allowance is indispensable to growth and Phoenix-like, it would rise again in some form or the other.

Depreciation allowance for assessment year 1991-92 in case of companies was restricted to 2/3 rds of the amount computed for the year. During the subsequent year, the substantive rate of depreciation on plant and machinery was reduced from 33.33 per cent to 25 per cent. In the context of continuing inflation and high replacement costs of assets, this move appears to be retrograde, and deserves reconsideration.

The country's tax levels were high for a developing economy. Simplification of tax laws and rationalization of a plethora of deductions was necessary so that the tax rates could be brought in alignment with those now prevailing in other developing and developed countries – say around 35 per cent as in certain South – East Asian

countries. This would lead to an increase rather than decrease in revenues, on account of stimulated work, production and incomes, and improved voluntary tax compliance. Choksi Committee had affirmed this, and it was also borne out by the experience in India and abroad.

Minimum taxes on companies have been proposed where (a) companies do not have taxable income for a number of years on account of major erosion of the tax base owing to tax holidays and large incentives, and yet they may be declaring hefty dividends; (b) evasion and avoidance take place; (c) certain companies may be declaring losses over a number of years raising doubts about the veracity of their accounts and (d) in situations of high inflation, accurate determination of profits may become difficult.

The minimum tax may be (a) related to economic income of corporations, that is, income without taking into account tax holidays and incentives; (b) linked to turnover of enterprises (say 1 per cent thereof), which can be more easily ascertained, with lesser scope for evasion and avoidance; or (c) calculated as a percentage of the gross assets of an enterprise, (say 1 per cent thereof). The minimum tax could be a final tax in lieu of conventional corporate tax or as a tax rebatable against corporation tax.

The Income Tax Act provided that with effect from accounting year 1987-8, where the total income of a company computed under the Act after deduction of allowances was less than 30 per cent of its book profit, the taxable income shall be taken as 30 per cent of such book profit. This provision was intended to subject the so-called 'zero-tax companies' to a minimum tax, even though they may not have any tax liability for the previous year under the provisions of law. The tax is inequitable; besides it is not realized that the term 'zero-tax companies' is a misnomer. Many of these corporate entities constitute the elite of the corporate sector and pay large amounts in excise duties, sales tax, and other indirect taxes, the quantum of which far exceeds whatever income tax may be payable. They

contribute substantially to G N P by increasing production, private employment, earn foreign exchange and through expansion of capital equipment, add to the capital stock in the economy. If they do not have income tax liability, because of their entitlement to depreciation and investment and other allowances, why should that be grudged ? After all, allowances are provided for the social and economic purposes of development, and these companies effectively perform this function. To term this avoidance, and tax it through minimum tax provisions in law, is to place initiative and efficiency at a discount.

The Government, in order to enforce payment of minimum tax by profit-earning companies, switched over to taxation of book profits. The scheme suffered from several flaws and complexities. The various allowances and rebates would not be available. Sick and new companies would experience difficulty in achieving viability. Besides, the dual concept of book profit and taxable profit adds to the complexity of tax laws. To the extent that the quantum of tax on book profits would reduce reserves, the debt-equity ratio would be affected and borrowing capacity for financing expansion eroded. The viability of many units would be affected. And if the management switches over to written-down value basis from straight-line basis of depreciation, the distributable profits would be reduced, with consequent deleterious effect upon share prices. N. A. Palkhivala expressed the view that it was constitutionally illegal, economically disastrous and discriminatory between companies and other categories of taxpayers. The Government has withdrawn the minimum tax on book profits with effect from the accounting year 1990-91. However, the minimum tax is being resurrected in the 1996-97 Budget in the form of Minimum Alternative Tax.

Most European countries in the post-War period experienced inflation, and this phenomenon made its impact felt upon the basis of depreciation allowed under the tax laws. While the normal basis is historical cost, various countries including Holland and Germany in 1948 after currency reform, Italy in 1962, and

Austria in 1954 allowed a writing up of assets so as to enable more realistic depreciation allowances out of profits before tax. This measure strengthened the corporate structure, making it easier for companies to cope with rising costs of machinery and other assets. The Netherlands allowed continuous revaluation of assets on the basis of replacement costs. In India, certain industries, notably sugar and paper, had represented for rehabilitation allowance on the basis of enhanced replacement cost of machinery in the computation of prices of their products; the claim does not appear to have been conceded so far. In income tax law also, provision does not exist for depreciation on replacement cost basis, despite an almost continuous upward surge in capital costs since the War. Most countries, including the United Kingdom, granted acceleration of depreciation in respect of specified assets by initial allowances; these could be claimed in the first year or spread over a number of years. Investment allowances in addition were permitted by the UK, Sweden, Italy, and some Swiss cantons, among others. The scheme of tax-free reserves as a tool for realization of fiscal and economic objectives has been successfully implemented in Western Europe; a similar scheme designed to serve as a fiscal instrument for stabilization and growth in India, along the lines of the Swedish system, appears to be called for. (Refer section 8.9)

8.6 Corporate Nucleus Capital (C N C) Super-Multiplier

Economic growth and employment are functions of aggregate investment in the economy. Net investment, in economic terms, according to J. M. Keynes, means⁶ the net addition to all kinds of capital equipment, after allowing for those changes in the value of the old capital equipment which are taken into account in reckoning net income. Investment, thus defined, includes, therefore, the increment of capital equipment, whether it consists of fixed capital, working capital or liquid capital.

The entrepreneur is the key figure for mobilizing various factors of production for investment. Capital is one of the principal factors for establishment of industry.

The major portion of nucleus capital or promoter's contribution is derived out of corporate funds mobilised by the entrepreneur, since personal savings owing to progressive taxation, are relatively small. In fact, even the entrepreneurial function these days, in certain cases, is taken over by corporate managements; certain large companies are promoted by a group of two or three corporations.

The central point in our thesis here is that an increase in reserves of corporations takes place consequent upon reduction in corporate taxes. This leads to an addition to the pool of funds available for providing nucleus capital for investment in new projects. Actually, if there is an addition to corporate reserves, it induces the management to undertake promotional activity in the establishment of new projects or expansion of existing plant or modernization, which leads to an increase in capital formation equal to a number of times such increase in corporate reserves. This is on account of what we call the 'Corporate Nucleus Capital Super Multiplier' effect, which may be explained.

A reduction in corporate tax rate would initially result in an increase in the post-tax profits of the company by an amount equal to the quantum of tax relief. This accretion to profits would either be transferred to reserve or distributed as dividends. The accretion to reserve in the case of the principal 500 industrial companies, would mostly be utilized for providing nucleus capital for expansion or for establishment of new projects or diversification into new lines of activity or modernization. Taking an over-all picture of utilization or accretion to reserves, it would be safe to conclude that not more than 10 per cent of the accretion to reserves would remain idle or be used for extraneous purpose. Another 15 per cent may be used as margin money for working capital.

An analysis of Sources and Uses of Funds in respect of 417 I C I C F assisted companies reveals that during 1986-87, Gross Fixed Assets increased by Rs.3121 crores and Investment by Rs.141 crores, aggregating Rs.3262 crores. Working Capital (Inventories Rs.633 crores, Receivable and Advances Rs.1079

crores, less Current Liabilities Rs.1003 crores) amounted to Rs.709 crores, while Cash and Bank balances were Rs.433 crores.

Addition to Fixed Assets and Investments worked out to 74.1 per cent, Working Capital 16.1 per cent and Cash and Bank Balances 9.8 per cent of the Net Outlay. This analysis is useful for our purposes, inasmuch as it provides confirmation that the ratio of investment of funds in working capital to fixed assets and investment is roughly 1:5, and that it would be appropriate to take utilization of incremental reserves for nucleus capital at 75 per cent, working capital at 15 per cent and funds kept idle or used for extraneous purposes at 10 per cent.

In the case of our theory of the C N C Super Multiplier, both the multiplier and the accelerator come into effect in an integrated manner. Hence, in order to distinguish the C N C effect from both the multiplier and the accelerator, we have termed it as C N C Super Multiplier.

Mathematically, we can express the C N C Super-Multiplier (M) as

$$M = \frac{R_t \times N_r}{N_e} (D_e + 1) *$$

Where R_t = the ratio of additional corporate reserve to the amount of tax cut (we can call it the reserve tax cut ratio).

N_r = the ratio of nucleus capital to additional corporate reserve (we can call it the nucleus - reserve ratio),

N_e = the ratio of nucleus capital to new equity capital (we can call it the nucleus - equity ratio), and

D_e = the ratio of new debt to new equity capital (we can call it the debt - equity ratio).

*An intermediate step in arriving at the above Formula is as follows :

$$M = R_t \times \frac{N_r}{100} \times \frac{100}{N_e} \times (D_e + 1)$$

For example, if $R_t = 1$ (i.e. the entire amount of tax cut is ploughed back to reserves), $N_r = .8$ (i.e. eighty per cent), $N_e = .4$ (i.e. forty per cent) and $D_e = 2$ then

$$M = \frac{1 \times .8}{.4} (2 + 1) = 2 \times 3 = 6 \quad \dots (1)$$

Which means that the ultimate total investment in the economy will be six times the original amount of additional corporate reserve due to tax cut.

If however, out of the tax cut, 50% thereof goes out as dividends and only the remaining 50% becomes additional corporate reserve, then $R_t = .5$ and we have now

$$M = \frac{.5 \times .8}{.4} (2 + 1) = 1 \times 3 = 3 \quad \dots (2)$$

A comparison of (1) and (2) clearly emphasizes the fact that the incremental profits due to a tax cut must be ploughed back to the reserves as far as practicable, i.e. the value of R_t must be as high as possible. Similarly, the values of N_r and D_e must also be as high as possible and the value of N_e as low as possible to make the value of M the highest.

We first assumed that the quantum of reduction in corporate tax is equal to accretion to reserves, on the basis that accretion to profits would not be distributed as dividends. An analysis of financing of companies financed by the I C I C I shows that retained profits as percentage of profits after tax amounted to 69.4 per cent in 1986-87 and dividends amounted to 30.6 per cent of profits after tax. These figures are largely representative and the ratio of profits transferred to reserves and distributed as dividends is often in the vicinity of 70:30, although there can be no hard and fast rule. It would appear that consequent upon reduction in taxes, if the post-tax profit increases, dividends may be increased, but in fact the broad experience is that the hike in dividends in response to lower taxes is less than in the same proportion. However, conservatively we have taken dividends as 50 per cent of profits after tax.

8.7 Case for Tax Rebate on Undistributed Profits of Companies

We would suggest that in order to maximize the incremental savings ratio in the corporate sector, a rebate of 20 per cent of the amount of transfer to reserves, being undistributed profits tax rebate should be given. This would be an added incentive to the management to restrain distribution of dividends and to plough back profits as much as possible.

Taking the corporate tax at 50 per cent and undistributed profits at 50 per cent of post-tax profits, the undistributed profits rebate would come to 5 per cent. In other words, the overall rate of effective taxation would then be 45 per cent instead of 50 per cent. We are of the opinion that if an undistributed profits tax rebate is provided, there would be an inbuilt automatic check on dividends, and the entire amount of reduction in tax may be ploughed back.

The utility of the C N C Super-Multiplier may now be indicated:

(1) The Super-Multiplier indicates the number of times addition to investment takes place in response to a reduction in corporate taxes by the Government. Thus, the Super-Multiplier constitutes an instrument in fiscal policy, which is useful (a) for assessing the effect of corporate tax reduction on additional investment and (b) for promoting investment through corporate tax cuts.

(2) Two of the determinants of the Super-Multiplier are percentage of promoter's contribution to equity capital and debt-equity ratio. A reduction in Promoter's contribution to equity capital would substantially increase the value of C N C Super-Multiplier and the quantum of addition to investment. Increase in debt-equity ratio also increases the Super-Multiplier and the addition to Investment. The debt-equity ratio is much higher in Japan, and this factor contributed substantially to stepping up industrial growth, and the rate of increase in G.D.P. In India and other developing countries also, the debt-equity ratio should be increased, and this may be combined with more intensive monitoring by financial institutions. As per our formula, the value of C N C Super-Multiplier

is higher at 5 in the case of capital-intensive industries, in whose case the institutional norm for debt-equity ratio is 4:1, as compared to 3 in the case of other industries with debt-equity ratio of 2:1.

(3) The theory of C N C Super-Multiplier has highlighted the need to provide undistributed profits tax rebate to companies. With a small sacrifice in revenue, this measure could ensure the maximization of incremental savings ratio in the corporate sector. It would provide a powerful instrument to induce corporations to plough back resources and restrict dividend distribution.

We have referred to the need to provide tax rebate on undistributed profits of corporations. In West Germany and Japan, corporate tax rebate is provided in respect of amounts distributed as dividends. This induces increase in dividend distribution to the maximum. While this may be justified in the case of developed economies, the postulates of growth for developing countries are different. Capital accumulation is of prime importance. The undistributed profits tax rebate would provide an incentive to management to plough back the greater part of their profits, while maintaining dividends at a reasonable rate. It would ensure the maximization of incremental savings ratio in the corporate sector.

8.8 Additional Excise Revenue and Accelerated Investment

We have seen that reduction in corporate tax results in an increase in overall investment in the economy by 3 times such relief, but this is not the end of the story. New projects are consummated within about two or three years. The ratio of sales to capital employed may be taken at 1:1, although it is often higher. Thus, if investment in new enterprises increased by about Rs.300 crores, sales would amount to Rs.300 crores, say in the third year. Taking excise duty at 30 per cent, the Government would obtain additional excise duty of about Rs.90 crores per annum from these concerns, besides other taxes.

Gross profit as percentage of sales normally works out to about 15 per cent. Taking corporate taxation at about 40 per cent, additional tax paid by companies

on sales of Rs.300 crores would amount to Rs.18 crores. Total additional revenue (including excise duty) should work out to Rs.108 crores.

Now let us consider the multiplier and the accelerator effects of the additional investment of Rs.300 crores on the economy. The overall receipts of the companies to the tune of Rs.300 crores would be distributed amongst the various factors of production in the form of wages, salaries, interest, profit *et al.* These amounts would provide further demand for wage goods and other consumer products, depending upon the marginal propensity to consume, emanating from the recipients of incomes. Assuming the marginal propensity to consume (M P C) at 50 per cent of income, the multiplier effect upon investment would work out as under.

$$\begin{aligned}\text{Multiplier K} &= \frac{1}{(1 - \text{MPC})} \\ &= \frac{1}{0.05} \\ &= 2\end{aligned}$$

Now, the effect of the accelerator may be considered. Increase in the consumption of certain commodities would inevitably increase the output of machines for production of those commodities. The accelerator measures the increase in investment goods industries consequent upon the increase in consumption goods industries. The accelerator thus gives the numerical value of the correlation between change in consumption and the consequent change in investment. Normally outlay on consumption goods industries of Rs. 1 crore leads to an investment of Rs. 1 crore in investment goods industries. This gives the accelerator the value of 1.

A new model emerges combining the multiplier analysis with that of the acceleration principle. Additions to national income may be taken to consist of three components: (1) governmental spending (2) private consumption expenditure

induced by previous public expenditure and (3) induced private investment, assumed according to the acceleration principle to be proportional to the increase in consumption.

If the Government increases expenditure by one dollar for the first time, addition to national income is by one dollar. This would yield in the second period fifty cents of consumption expenditure. Since there is an increase of 50 cents of consumption expenditure ($M P C = 0.50$) over the previous period, according to the accelerator principle induced private investment will also increase by 50 cents (Accelerator=1). Adding one dollar of government expenditure, the addition to national income of the second period will total two dollars⁸.

Applying this to our case, we find that in the second period, there is an increase of Rs.150 crores induced consumption (being 50 per cent of the initial increase of Rs.300 crores in consumption expenditure) and a further increase of Rs.150 crores in induced investment (accelerator being 1). The national income increases by Rs.600 crores, including the initial increase in consumption expenditure of Rs.300 crores. In subsequent rounds, the effect of the Multiplier and Accelerator weaken.

Reverting to our original proposition, it would be observed that thanks to the effect of (1) C N C Super-Multiplier (2) Investment Multiplier and (3) Acceleration Principle, the original reduction in corporate taxes by the Government by Rs.100 crores results initially in increase in investment and income of factors of production by Rs.300 crores; and subsequently over a certain period, by Rs. 600 crores, including induced increase in consumption goods industries Rs.150 crores and investment goods industries Rs. 150 crores.

It is significant that if the marginal propensity to consume was higher than 50 per cent of income assumed by us on a conservative basis and the accelerator was more than unity (one), the total increase in investment and national income would be still higher.

8.9 Tax - Free Reserves for Stabilization in India

In an article in *The Economic Times* as early as in 1968, the present scholar suggested that the Indian Government should consider measures that would provide tax relief without appreciable loss of revenue. Properly evolved, a scheme of tax - free reserves, basically as prevalent in the West European countries, could be forged into a useful multi - purpose fiscal instrument. Investment, in the process of growth, often needs to be channelized in certain industrial sectors, to which capital, on account of the risk factor or projections of low return, may not be willing to flow without inducement. Such a scheme could be geared to directing investment (a) into industrial sectors which need to be buttressed; (b) to underdeveloped regions; and (c) for replacement of worn - out or obsolescent plant and machinery.

It was suggested that the authorities may allow the transfer of 20 per cent of the assessable profit to a tax - free reserve, out of which, say 50 per cent could be required to be deposited with the Reserve Bank of India. Within a period of three years, the Government might release the blocked reserve with such directive for investment as was deemed necessary in the national interest. While the corporate sector would be benefited by the tax relief, the Government would acquire control over a substantial part of the money for a certain period and its ultimate disposition. It could be integrated with other fiscal and monetary measures for pre - determined objectives, including regulation of the total flow of investment in the economy during any given period. The authorities need not adhere to a fixed schedule with regard to the timing of release and could effect it at their discretion. Thus it could serve as a reserve for stabilization evolved in the Scandinavian and other European countries.

8.10 Some Recommendations

Depreciation : The basic rate of depreciation in respect of plant and machinery should be increased to 33.1/3 per cent, since it is calculated on historic cost

basis. Depreciation on other assets including office equipment, building, furniture and fixtures, factory shed, railway siding *et al*, should also be raised. In order to stimulate expenditure on pollution control and safety equipment – which promote social objectives – depreciation should be enhanced to 125 per cent of cost incurred on a weighted basis.

Social Infrastructural Expenditure : Where limited companies undertake social infrastructural activities, like building schools, hospitals, roads and amenities in rural areas particularly, such expenditure should be fully allowed as deduction.

Conditionalities : Certain incentives are provided in the income tax law. These are designed to promote certain objectives, and are formulated after due consideration. Such incentives should not be hedged by various procedural and other conditionalities, making it difficult for assesseees to claim them. Whatever may be the quantum of allowance, the scheme should be simple and definite, and there should be no room for exercise of discretion by the officers to disallow it.

Bona Fide Expenditures : Bona fide expenditures on guest houses, entertainment and travelling should be fully allowed as deduction from expenditure. Actually this would lead to better voluntary compliance of laws, as disallowances provide excuse for accounting adjustment by assesseees which is undesirable.

Dividends from Foreign Joint Ventures and Off - shore Subsidiaries : Such dividends should be exempt from tax. The objectives of stimulating foreign trade and globalization are promoted through strategic alliances leading to formation of subsidiary companies. Dividends remitted to Indian promoters in foreign exchange should be treated at par with export earnings and accorded concessional tax treatment.

Advance Rulings : Such rulings for non - residents have been improvised in tax law; it should be considered whether the principle could be extended to assesseees in general. A substantial fee may be charged to eliminate frivolous or minor references.

Modernization Allowance : Tax reforms should contribute to increasing the built-in elasticity of the tax structure. We have seen that corporate taxation essentially has elasticity inbuilt; this could be further increased by providing fiscal incentives for growth. In this context, a tax free modernization of machinery reserve could increase competitive capacity. This would be reflected in higher revenues.

Simplification of Laws to Improve Voluntary Compliance : Laws should be simple and easy to understand and administer, with least amount of discretion being vested in the officers. As the Meade Committee (UK)⁹ rightly stated, the tax system should be acceptable to the public, and simplicity and transparency of the tax system is necessary for acceptability. The taxpayer should know what is taxable. The principle on which the tax base is chosen should itself be simple and easy to perceive. The tax administration in a democratic system should be accountable to the people. The administration should be modernized and tax procedures and regulations simplified. All these factors would contribute to better compliance of tax laws. Repeated demand for taxes which have been paid is common occurrence. The introduction of pass book for tax payments would obviate this and save time of both the assessee and the Department and provide for better housekeeping.

Consistency of Laws with Development Strategy : Tax reforms should be in consonance with the development strategy. If development of infrastructure is a priority item on the agenda of economic reforms, and power, oil and other industrial complexes are capital-intensive with long gestation periods, it may be necessary to incorporate in the tax structure investment or development allowances in order to attract foreign capital for investment. Since gestation periods were long and devoid of dividend payment, tax rebate to investors in shares of new companies incorporating such projects was necessary to induce such investment. Actually, the withdrawal of rebate on investment in shares of new companies

was not justified in the present context, when capital markets were being enlarged, greater investment habits fostered and need to raise capital for new ventures had greatly increased. Similarly, backward areas development was an item of high priority in national development. The withdrawal of backward areas tax rebate was a retrograde step and *status quo ante* needed to be restored.

Mitigating Tax-induced Erosion of Efficiency and Incentives : According to Asian Development Bank,¹⁰ tax reforms in developing countries should substantially mitigate tax - induced efficiency - reducing distortions. South Asian countries had increased corporate taxes solely with the objective of raising revenues, irrespective of the adverse effects on efficiency, incentives and compliance in the generation of such revenues. While the corporate tax level in most East Asian countries was in the 30 - 35 per cent range, corporate taxation in India was increased as a revenue-raising measure to 51.75 per cent for public companies and 57.5 per cent for controlled companies in 1991 - 92 Budget. The level of taxes for small companies with incomes less than Rs.5 lakhs was also the same. These taxes reduced the net marginal efficiency of capital, and had a disincentive effect upon domestic investment, inflow of direct foreign investment and voluntary tax compliance. It also reduced corporate cost consciousness. Since then corporate tax levels have been reduced and the tax on public companies is 46 per cent for assessment year 1995-96.

Chapter 8 References

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