

## 9. POLICY IMPLICATIONS

In this chapter, we intend to bring together the implications of the results of the study running over the last four chapters. It must be emphasised, at the risk of being repetitive, that our calculations are *not* complete, as no adjustment was made for net financial liabilities. We can make a fairly reliable guess as to their direction (which would be to raise real profits), but our guess about their magnitude would be, in the circumstances, very tentative for reasons explained earlier in the text as well as in Annexure I.

The implications that are traced below are based on the assumption that the adjustment for financial liabilities would not be large enough to cancel out the other two adjustments to such an extent as to render the total inflation adjustment altogether insignificant. Thus, our conclusions that follow are based on the presumption that inflation does reduce the real profits substantially under current tax laws and causes significant overtaxation of the return on corporate capital. Given the debt-equity ratios, average length of time during which loans are kept outstanding, and the absolute amounts of net financial liabilities *vis-a-vis* gross fixed assets, we believe this presumption to be reasonable for the corporate manufacturing sector, as stated earlier. If the conclusions seem too strong to be credible, it is perhaps because they are based on published accounts, which it is sometimes alleged, do not always reflect the true economic position of the companies.<sup>1</sup> For a study like the present one, however, there is no alternative.

### 1. Implications for Investment

Our results show that the post-tax real profits are considerably reduced due to inflationary conditions through the corporation income tax structure. Profitability and retained earnings

<sup>1</sup>See, for example, Mahindra (1985), "Managing the Bottom Line", *Chartered Accountant*, Vol. 34, pp. 202-206.

are important determinants of investment on the demand and supply sides respectively, and so the adverse impact of inflation on investment through the tax mechanism can easily be deduced. Additionally, as explained earlier, the combination of inflation and historical cost-based tax laws amount to siphoning off resources from the private sector to the public sector. This almost certainly affects the supply of investible capital to the private sector from the same.

Moreover, as we have seen, the deleterious effects of historical cost-based corporation income tax in inflationary periods are not uniform across companies. They seem to snowball over the years, so that older companies are hit harder than the new companies. Also, the impact over industries differs. This implies that the selection of investment projects becomes sub-optimal as the ranking of the projects according to the social rates of return differs from that by the private rates of return.

## **2. Implications for Capital Structure**

Corporation income tax, as is well-known, discriminates in favour of debt because of the interest deductibility provision in the tax laws. Inflation probably strengthens this discrimination, since, while the desired rate of return on shares rises in nominal terms with inflation, the rate of interest on debt is usually fixed in nominal terms because of its contractual nature.

Quite apart from this, our results indicate that under inflation the corporation income tax causes capital erosion in real terms. To keep capital intact, the companies have to get additional capital (either debt or share issues) continually. In the absence of inflation and its impact on real profits through the corporation tax, these would not be necessary as retained profits would be used for growth. To the extent that the additional capital mentioned above is in the form of debt, inflation is further contributing to the tendency towards higher debt-equity ratios.

## **3. Profit Allocation**

The basic effect of historical cost-based system is, of course, on profits. However, the way companies are adjusting

themselves to the real profit crunch is of interest to us, because those actions are likely to cause further ripples in the economy. Of special interest is the way the nominal profits (which, in real terms may not be profits at all, or at least much lower) are used.

Considering operating profits, they can be allocated to four heads: tax provision, tax-induced savings, dividends, and retentions.

Among the four, as the figures show, dividends are paid more or less regularly. It seems to be a puzzle that in spite of the possibility of paying shareholders through capital gains (higher retentions would raise the market value of the shares) which are lightly taxed, and, more importantly, the fact that real profits are too small to pay dividends, dividends are paid so regularly. No firm explanation can be provided for this phenomenon except for the possibility that the shareholders demand a regular stream of income without having to go through capital market operations every once in a while. As our results show, this behaviour costs the companies valuable investible capital which they have to raise from the capital market. This is because of the fact that given post-tax profits, the higher the dividends, the lower are the retained earnings.

As for the tax-induced savings (development rebate/investment allowance), ability of the companies to take advantage of these are actually quite limited because of the low real profitability. However, as it is, the high effective real tax burden must be forcing the companies to place undue emphasis on tax planning to save on taxes and probably forcing them to save under these heads more than they would otherwise do. Even after taking full advantage of these tax incentives, the companies only have some tax-free resources at their command with certain restrictions. Without inflation or with an inflation-adjusted tax base, they would have a large portion of the same resources (again tax free, because then these would be properly deducted from the tax base as legitimate deductions and allowances) to use as they see fit. This means they would use it in a way which would maximise their returns, whereas the restrictions on tax-induced savings may force them to use such savings sub-optimally, causing inefficient allocation of resources. Thus, although inflation-adjusted tax base may

result in smaller amounts saved as investment allowances, it may achieve the ultimate goal of capital formation in a more efficient manner. After all, indiscriminate reinvestment is not even socially desirable.

Tax provision (and tax revenue to the government) would certainly be smaller if inflation accounting is allowed because of the smaller tax base, but even from the long-run revenue point of view, it is desirable to adjust the tax base for inflation. Otherwise, overtaxation on a continuous basis would hamper the growth of the corporate sector, which would cause the tax revenue to fall in the long run. The lacklustre growth of the corporate sector *vis-a-vis* the non-corporate business sector is already well-documented. With a reasonable tax policy, the long-term prospects of a healthy corporate sector, and hence a steady flow of tax revenue, seem both possible and desirable. In any case, if a particular measure eliminates important inefficiencies in the system, makes it more neutral, and encourages growth, revenue considerations should not come in the way of implementing such a measure. There are examples of other countries where the revenue authorities have themselves advocated some sort of inflation adjustment (e.g., the Treasury Department proposals in the USA). It goes without saying, however, that such reforms cannot be made in isolation, but the whole tax system has to be suitably revised. Otherwise, while trying to eliminate one distortion, a number of others will emerge.