3.1 INTRODUCTION

Economic growth relies heavily on raising the rate of savings and the level of investment. Taxation reforms in low-income, developing economies like India have yielded beneficial results such as reduction in the marginal rates of personal income tax and corporate income tax and the abolition of tax on income from interest. It is argued that heavy taxation on productive income is detrimental to private capital formation. Several studies (Trela & Whalley, Tanzi & Zee) have shown that tax policy and tax mix strategies have made an important contribution to economic growth in developing economies. If there is a discernible influence of taxation policy on capital accumulation and economic growth, then there may be lessons to be learnt for India from its own past experience. Hence, this chapter deals with the general idea about corporate taxation and its importance in Indian industries.

3.2 CORPORATE TAXATION

The corporate tax system in India underwent a major change during 1959-60, when the partial imputation system was replaced by the classical system of taxing corporate income. Unlike the present classical system, the partial imputation system provided credit to the shareholder for the corporate tax paid on the company's distributed corporate profits. The current system treats the company as a separate legal entity and there is no allowance or credit given to the
shareholders for any part of the tax paid by the company on the distributed components of profits. The Chelliah Committee\textsuperscript{3} reiterates the merits of continuing the classical system of providing no relief in respect of dividends, on which the taxpayer has already paid tax, to be retained in the short run.

Full indexation, a well-designed indexing system of estimating the tax burden, will solve many problems. The Committee remarked that businessmen favour partial indexation and often complain that the depreciation allowance based on the book value of each asset does not reflect the true value, since it fails to consider the inflation component. They argue that partial indexation of fixed assets takes care of this problem. At the same time, they fail to recognize the benefit that accrues to them from debt financing when not indexed for inflation. Full indexation, unlike partial indexation, not only protects business allowances but also protects the creditors who have provided the debt finance.

3.3 CORPORATE TAXATION AND FOREIGN INVESTMENT

The past two decades have witnessed important developments in the restrictions imposed by nations on international investment. During this period, the vast majority of countries have either reduced or entirely eliminated controls on cross-border flows of capital and foreign exchange. This has lead to an increase in the international mobility of capital, evidence for which has been provided by many researchers\textsuperscript{4}. A rapid expansion in the level of foreign direct investment has consequently occurred. According to the World Trade Organisation, the world volume of foreign direct investment rose by over 700 per cent between 1970 and 1996, a much faster rate of growth than that of world Gross Domestic Product and
nearly double that of world trade. There has also been significant growth reported in the importance of such investment to the economies of individual countries. For Western Europe as a whole, foreign direct investment inflows in 1997 were equivalent to approximately 8.6 per cent of total gross fixed capital formation; in individual countries, for example Ireland, the figure came to 19.0 per cent.

One of the consequences of the dismantling of barriers to international investment is that in their absence corporate taxation is seen as assuming a greater role in determining the location of those funds, through its ability to influence the returns from investment. The role of corporate taxation has also been enhanced in recent years by reductions in non-tax costs of transferring capital. The presence of international differentials in corporate taxation is now perceived as one of the few remaining government-induced distortions to the global free flow of capital.

In such a situation, one might expect to observe the greater use of corporate tax policy by governments in encouraging investment from overseas. Indeed, this appears to have been the case, recent years have seen significant reforms in corporate tax in many countries. These reforms, which first appeared in United Kingdom and United States in the early Eighties, were soon followed in several other Western countries, and then more widely around the world. The reforms had, as their most significant common characteristics, a reduction in statutory tax rates together with broadening of the tax base. Although the reforms had their origin in political developments and a desire to improve economic efficiency, their widespread adoption is thought to have been caused, at least in part, by the increased need for governments to compete in the new liberalized environment for investment from overseas (or, at least, by the need to protect their existing stock of
investment from disappearing abroad). The consequent decline (and convergence) of corporate tax rates around the world has been widely seen as evidence of this modern phenomenon of "tax competition".

The above global developments raise two important questions. First, how important currently is the influence of corporate taxation on the flow of international investment? Taxation is likely to have some effect upon the investment location decisions of corporations. It is the strength of that effect that is important to potential tax reformers in considering whether any change in taxation would be worthwhile to attract investment. If such investment is not responsive to changes in taxation in the potential host country, then encouraging investment through use of the tax system is not only pointless but also possibly harmful to the country's economy in terms of the potential tax revenues foregone.

In the Indian corporate sector, a large discrepancy between the scheduled tax rate and effective tax rate was observed in the late 1970s and early 1980s. Generally, it is assumed that this discrepancy is the result of the use of various tax exemptions. From the tax account of some of the large individual companies from big business houses, it was argued that large companies do take advantage of these tax exemptions and pay less taxes than they were supposed to. To control this in 1983 the central government in its budget proposals introduced the provision that each company had to pay tax on at least 30 per cent of their pre-incentive profit. This was changed in the budget proposal of 1987-88, under which companies had been liable to pay tax on a minimum of 30 per cent of their book profits. Finally, in the 1990-91 budget proposal, this provision was abolished with effect from the assessment year 1991-92.
In 1996, the government introduced the minimum alternative tax in order to reduce the number of zero tax companies. Recently, the Kelkar task force on direct tax suggested the removal of tax exemptions and reduction of the scheduled tax rate. So, it is argued that the effective tax rate is likely to increase with the consequent increase in tax revenue. Apart from this, as it is assumed, tax exemptions help some companies to have less effective tax rate, the principle of equality will also be ensured by removing the provisions for tax exemptions.

3.4 TAXATION AND THE OPEN ECONOMY

In this era of globalization, taxation policy needs to take into account the fact that any economy is part of the global economy. With globalization, the economies of the world are more closely related and the tax reforms of large open economies, like United States and Japan, affect small open economies, such as India. Tax policy in many countries in the 1990s aimed at reducing the rates of personal and corporate income tax and raising the tax threshold to promote savings and capital formation. A series of tax reforms emerged in response to intellectual, historical and political debates of the 1970s.

High marginal tax rates and differential tax treatment imposed on economically similar activities resulted in distortions and large-scale tax evasion during this period. The 1970s was also a decade with relatively high inflation (caused by oil crisis), which artificially increased the tax burden for the middle class. The outcome was the diversion of productive resources into unproductive investment and tax shelters. However, the globalization of the world economy put pressure on small open economies to respond to the tax reforms of large open economies.
3.5 TAX REFORMS IN INDIA

There have been major changes in tax systems of countries with a wide variety of economic systems and levels of development during the last two decades. The motivation for these reforms has varied from one country to another and the thrust of reforms has differed from time to time depending on the development strategy and philosophy of the times. In many developing countries, the immediate reason for tax reforms has been the need to enhance revenues to meet impending fiscal crisis. As Bird states, "fiscal crisis has been proven to be the mother of tax reform". Such reforms, however, are often ad hoc and are done to meet immediate exigencies of revenue. In most cases, such reforms are not in the nature of systemic improvements to enhance the long run productivity of the tax system.

In India, the first comprehensive attempt at reforming the tax system was by the Tax Reform Committee in 1953. This provided the backdrop for the generation of resources for the Second Five Year Plan (1956-60), and was required to fulfill a variety of objectives such as raising the level of savings and investment, effecting resource transfer from the private to the public sector and achieving a desired state of redistribution.

Since then, there have been a number of attempts, most of them partial, to reform various aspects of the tax system. On the indirect taxes side, a major simplification exercise was attempted by the Indirect Taxes Enquiry Committee in 1972. At the state and local level, there were a number of tax reform committees in different states that went into the issue of rationalization and simplification of the tax system. The motivation for almost all these committees was to raise more revenues to finance ever-increasing public consumption and investment requirements.
Although the effect of the rationalization has been to reduce the marginal tax rates, the prevailing philosophy still dictated keeping the rates very high. It may be noted that in the early 1970s the marginal tax rate including the surcharge was as high as 93.5 per cent. Combined with the highest marginal wealth tax rate of eight per cent tax on wealth, the tax system produced enormous incentives for evasion and avoidance of the tax. On the recommendation of the Direct Taxes Enquiry Committee, the marginal tax rate was brought down to 77 per cent in 1974-75 and further to 66 per cent in 1976. Similarly, the highest wealth tax rate was reduced to 2.5 per cent. On the indirect taxes front, the most important reform before 1991 was the conversion of the union excise duties into a modified value added tax (MODVAT) in 1986. The MODVAT was introduced in a limited manner on a few commodities and the coverage was gradually extended over the years. It was an income type VAT applicable only to a few manufactured goods. Also, there was an attempt to substitute ad valorem taxes to specific levies though quite a few commodities are subject to specific tax even today. There were attempts to simplify and rationalize the structures, but these cannot be considered comprehensive. As in other countries, the systemic reforms in the tax system in India in the 1990s were the product of crisis but the reforms were calibrated on the basis of detailed analysis.

The philosophy of tax reform has undergone significant changes over the years in keeping with the changing perception of the role of the state. With the change in the development strategy in favour of market determined resource allocation, the traditional approach of raising revenues to finance a large public sector without much regard to economic effects has been given up. The recent approaches to reform lay emphasis on minimizing distortions in tax policy to keep
the economy competitive. Minimizing distortions implies reducing the marginal rates of both direct and indirect taxes. This also calls for reducing differentiation in tax rates to reduce unintended distortions in relative prices.

In India, there have been frequent changes in the rate structure during the past 50 years. There have been changes in the rate structure during every budget or every alternate budget. The reasons for the frequent changes have been differences in the views of Finance Ministers, and there have been times when the same Finance Minister has changed his opinion over the rate structure within a span of two years. It is argued that the rate structure can be devised to ensure growth with equity if there is stability and no change in the rate structure at least for a period ranging from three to five years\textsuperscript{13}.

During 1990s, the Indian government attempted to simplify not only the personal income tax structure, but also the corporate income tax structure. The base for corporate income tax is arrived at after deducting expenses and tax concessions either partially or totally from the company's profits. The domestic company tax rate, in which the public is substantially interested, declined from 55 percent in 1984-85 to 45 percent in 1994-95.

There have been a number of attempts at improving the tax system since independence prior to economic liberalization in India. The principal objective of these attempts has been to enhance revenue productivity to finance large development plans. Although the various tax reform committees considered economic efficiency as one of the objectives, the recommendations do not bear much testimony to this aspect. The recommendations were in keeping with the
philosophy of the times. Further, even when the committees did recommend certain measures on efficiency considerations, this was not acted upon if it involved loss of revenues.\footnote{footnote14}

In India, prior to comprehensive economic reforms (1991), the buoyancy in tax revenues was fuelled by the progressive substitution of quantitative restrictions with tariffs following initial attempts at economic liberalization in the 1980s, in addition to the economy attaining a higher growth path. In the first, right from the 1970s to mid-1980s, there has been a steady increase in the tax-GDP ratio in keeping with the buoyant economic conditions and acceleration in the growth rate of the economy. There was a steady increase in tax ratio. The economic recession following the severe drought of 1987 resulted in stagnation in revenues in the second phase until 1992-93. Following the economic crisis of 1991 and the subsequent reforms in the tax system, particularly reduction in tariffs, actually caused a decline in the tax ratio. Overall, the level of tax revenues, although reasonable as compared to the average tax level in developing countries, is clearly inadequate from the viewpoint of resource requirements of the economy.

Tax reform since 1991 was initiated as a part of the structural reform process, following the economic crisis of 1991. In keeping with the best practice approaches, the Tax Reform Committee (TRC) adopted an approach of combining economic principles with conventional wisdom in recommending comprehensive tax system reforms. The reforms were to be calibrated to bring about revenue neutrality in the short term and to enhance revenue productivity of the tax system in the medium and long term. The overall thrust of the Tax Reform Committee
was to (i) decrease the share of trade taxes in total tax revenue; (ii) increase the share of domestic consumption taxes by transforming the domestic excises into VAT and (iii) increase the relative contribution of direct taxes.

The important proposals put forward by the Tax Reform Committee included reduction in the rates of all major taxes, viz. customs, individual and corporate income taxes and excises to reasonable levels, maintain progressively but not such as to induce evasion. It also recommended that the taxes on domestic production should be fully converted into a value added tax, and this should be extended to the wholesale level in agreement with the states, with additional revenues beyond the post-manufacturing stage passed on to the state governments.

In the case of corporate income taxes, the rates were progressively reduced on both domestic and foreign companies to 35 per cent and 48 per cent respectively. The dividend tax at the individual income tax level has been abolished. However, very little has been done in terms of broadening the base of corporation tax. In fact, besides depreciation allowances and exemptions for exporters, generous tax holidays and preferences are given for investment in various activities (housing, medical equipment, tourism, infrastructure, oil refining, free trade zones, software development, telecommunication, sports etc.). Consequently, the tax base has not grown in proportion to the growth of corporate profits. As many corporate entities took generous advantage of all these tax preferences, there were a number of “zero-tax” companies. To ensure minimum tax payments by them, a Minimum Alternative Tax (MAT) was introduced in 1997-98.
3.6 TAX RATES IN INDIAN CORPORATE SECTOR

Corporate tax in India is a fixed percentage of the net profit after allowing admissible expenses. It has to be self-assessed in nature. During the last two decades, the corporate tax rates underwent repeated changes. The tax rates and surcharge applicable to companies for various assessment years are presented in Table 3.1.

It can be observed from the table that, at the beginning of the 1980s, the scheduled tax rate was around 60 per cent, but by the end of that decade it came down to the range of 50 to 54 per cent. In the year 1991-92, the scheduled tax rate came down to 46 per cent for private and public limited companies.

In the year 1992-93, the scheduled tax rate was increased to 52.5 per cent. From 1992-93 to 1999-2000, the scheduled tax rates were reduced or remained the same in almost all the years. But by 1999-2000, the scheduled rate was reduced to 35 per cent, for companies. Following the introduction of surcharge, the scheduled rate again climbed up in 2000-01 and 2001-02. Reduction in the surcharge once again brought down the scheduled tax rate close to 35 per cent for the assessment year 2002-03.

The surcharge was again increased to 5 per cent in 2003-04, but again brought down to 2.5 per cent in the very next year and kept at the same level in 2005-06 in turn amounting to scheduled tax rate of 35.875 per cent.
Table 3.1
Income Tax and Surcharge for Private and Public Limited Companies for Assessment Years: 1980-81 to 2006-07

<table>
<thead>
<tr>
<th>Assessment Year</th>
<th>Income Tax Rate (%)</th>
<th>Surcharge (%)</th>
<th>Scheduled Tax Rate (%)</th>
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<tr>
<td>1980-81</td>
<td>55</td>
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<td>59.125</td>
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<td>2.5</td>
<td>56.375</td>
</tr>
<tr>
<td>1984-85</td>
<td>55</td>
<td>5.0</td>
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</tr>
<tr>
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<td>55</td>
<td>5.0</td>
<td>57.750</td>
</tr>
<tr>
<td>1986-87</td>
<td>50</td>
<td>5.0</td>
<td>52.500</td>
</tr>
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<tr>
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<td>50</td>
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<td>52.500</td>
</tr>
<tr>
<td>1989-90</td>
<td>50</td>
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<td>52.500</td>
</tr>
<tr>
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<td>50</td>
<td>8.0</td>
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</tr>
<tr>
<td>1991-92</td>
<td>40</td>
<td>15.0</td>
<td>46.000</td>
</tr>
<tr>
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<td>45</td>
<td>15.0</td>
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</tr>
<tr>
<td>1993-94</td>
<td>45</td>
<td>15.0</td>
<td>51.750</td>
</tr>
<tr>
<td>1994-95</td>
<td>45</td>
<td>15.0</td>
<td>51.750</td>
</tr>
<tr>
<td>1995-96</td>
<td>40</td>
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<td>46.000</td>
</tr>
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<tr>
<td>1998-99</td>
<td>35</td>
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<td>35</td>
<td>0.0</td>
<td>35.000</td>
</tr>
<tr>
<td>2000-01</td>
<td>35</td>
<td>10.0</td>
<td>38.500</td>
</tr>
<tr>
<td>2001-02</td>
<td>35</td>
<td>13.0</td>
<td>39.550</td>
</tr>
<tr>
<td>2002-03</td>
<td>35</td>
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<td>35.700</td>
</tr>
<tr>
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<td>35</td>
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<td>36.750</td>
</tr>
<tr>
<td>2004-05</td>
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<td>2.5</td>
<td>35.875</td>
</tr>
<tr>
<td>2005-06</td>
<td>35</td>
<td>2.5</td>
<td>35.875</td>
</tr>
<tr>
<td>2006-07</td>
<td>30</td>
<td>10.0</td>
<td>33.000</td>
</tr>
</tbody>
</table>
Notes: (1) For 1990-91 surcharge rate was 8 per cent of corporate tax of a domestic company, if total income exceeds Rs 50,000.

(2) 1991-92 to 1996-97 surcharge at the rate of 15 per cent of corporate tax of a domestic company, if total income exceeds Rs 75,000.

(3) 1997-98 surcharge at the rate of 7.5 per cent of corporate tax of a domestic company, if total income exceeds Rs 75,000.

(4) 2000-01 surcharge at the rate of 10 per cent on corporate tax is payable by the domestic company on the whole amount of income tax.

(5) 2001-02 surcharge at the rate of 13 per cent on corporate tax is payable by the domestic company on the whole amount of income tax.

(6) 2002-03 surcharge at the rate of 2 per cent on income tax is payable by the domestic company on the whole amount of income tax.

(7) 2003-04 surcharge at the rate of 5 per cent on income tax is payable by the domestic company on the whole amount of income tax.

(8) 2004-05 to 2005-06 surcharge at the rate of 2.5 per cent on income tax is payable by the domestic company on the whole amount of income tax.

(9) 2006-07 surcharge at the rate of 10 per cent on income tax is payable by the domestic company on the whole amount of income tax.

Source: Budget documents of various years, Government of India.

In 2006-07, there has been reduction in the corporate income tax rate from 35 per cent to 30 per cent. However, the surcharge has been increased from 2.5 per cent to 10.0 per cent. Due to which the scheduled tax rate is as low as 33.00 per cent in 2006-07.

To prevent companies from reducing their tax liability to zero, the Finance Act 1996-97 introduced the minimum alternative tax. From the assessment year 2000-01, minimum alternative tax has been levied uniformly at 7.5 per cent of the
book profits as determined under the Companies Act\textsuperscript{16}. In the Indian corporate tax system, a variety of concessions in the form of tax exemptions are provided to corporations, which resulted in substantial reduction in their overall tax liabilities. It may be the cause of lower tax provision by the Indian corporate sector, as a percentage of the profits before tax than the scheduled rates.\textsuperscript{y}

The data also shows that large companies' effective tax rate has been comparatively lower than small companies. The effective tax rate was nearly 49 per cent in 1975-76, it fell to nearly 28 per cent by 1989-90 and after experiencing considerable fluctuations, it reached just a little over 22 per cent by 1999-2000. What is striking is that except in 1980-81, in all the years, effective tax rate of the small companies as a group was higher than that of the larger companies, which in turn have prompted the researcher to find out the role of company characteristics, (including the size) that influence companies' effective tax rate\textsuperscript{17}.

Interest payment is a very major item for which tax exemption is available. For the selected companies of the manufacturing sector for the period from 1992 to 2001 interest payment constitutes more than 30 per cent of profit before interest, depreciation and tax. So the leverage of a company should be a very important explanatory variable for effective tax rate and vice versa. Companies with higher leverage should have lower effective tax rate. A company’s asset mix can also affect its effective tax rate. Tax benefits are provided for capital investment. For example, tax laws allow companies to write-off the cost of tangible depreciable assets over periods much shorter than their economic life. So companies with higher capital intensity should have lower effective tax rate\textsuperscript{18}. 

\textsuperscript{y}
3.7 INCENTIVES FOR SAVINGS AND INVESTMENT

Since 1990s, there has been a greater emphasis on private investment to promote a higher growth rate in the economy. One useful theory of how businesses decide how much to invest depends upon the cost of capital. The higher the interest rate, the greater will be the cost of funds and the lower the incentive to invest. While there is still disagreement on the responsiveness of various kinds of investment to tax incentives, there is a consensus of opinion on the positive effect of tax incentives provided for plant and equipment.

The choice of a rational investment incentive will provide a true incentive for covered investments, while at the same time guarding against gross and avoidable inefficiencies. The Indian tax laws (Income Tax Act, 1961 and Wealth Tax Act, 1957) have a vast range of incentives specifically designed to increase the productivity of private industries. Recently, a five-year tax holiday provision has been extended to include investment in irrigation, water supply, sanitation and sewerage systems.

All of these tax policy measures (decrease in personal income tax rates, increase in the tax threshold, reductions in the number of slabs, reductions in the corporate income tax rate and other tax changes) have resulted in a decline in the tax mix ratio in India.

3.8 TAXATION AND CORPORATE GROWTH

Few countries in the world levy tax on corporate earnings twice, where equity earnings are taxed on the corporate level and again for the individual receiving dividends or capital gains. Generally, tax rates for personal taxes on
investment income are lower than corporate rates. These combine corporate and personal taxes tend to substantially increase government's stake, reduce retained earnings and capital reinvestment, and increase the firm's cost of capital. Stockholders take most of the risk of undertaking new ventures; however, if successful, government may take over a large percentage of equity value. If the venture is successful, government takes its share; however, if the venture is unsuccessful, government's risk is an opportunity cost, but the stockholder's cost is real. These factors combine to reduce the set of viable capital investment projects. The burden of corporate taxation eventually falls on stockholders, thus we recommend that all or most corporate taxation be shifted to individuals instead of the current combination of corporate taxes and personal taxes on dividends and capital gains. This strategy may be structured to be tax neutral but frees the engines of corporate growth leading to a win-win situation for all stakeholders.

Allowing corporations to increase capital investment as a result of reduced corporate taxes increases government's tax revenues despite a declining proportional stake in firms. An effective method of implementing such a strategy is to make both corporate dividends and domestically reinvested retained earnings tax deductible. Essentially, removing corporate tax should increase corporate growth and increase personal income in the form of higher dividends and capital gains. To the extent that the growth in personal income levels is insufficient to make up for the lost corporate tax revenues, higher personal tax rate on dividends and capital gains may be applied.

A firm that does not have real growth opportunities should return excess capital to investors who could then reinvest in other growth firms. Thus, allowing
corporations to deduct dividends from corporate taxable income is justified. Otherwise, taxing dividends may create distorted incentives for firms to over-invest, given the tax benefits of reinvestments. Furthermore, a policy that encourages dividend payments will enhance personal tax revenues that the government may collect immediately.

3.9 AN OVERVIEW OF INDIAN INDUSTRIES

Industries in India are corporate groups in a widely prevalent organizational form like in most emerging markets and in many developed economies. They play a prominent role in the economies of our country and contribute to a significant proportion of the nations' output. Organized economic activity in India remained relatively fragmented until the advent of British rule. After the cessation of monopoly rights of the British East India company, rival British merchants set up several trading houses. Indigenous business groups such as the TATAs emerged in the late 19th century. The corporate sector in India can be broadly classified into two categories: companies owned by government and privately owned companies. These government and privately owned companies can be further sub-categorized into widely held (Public limited companies) and those that are closely held (Private limited companies).

These privately owned companies include joint sector companies (representing collaborative ventures between the government and the private sector) and subsidiaries of foreign multinational enterprises. Post independence, there has been a rapid growth in corporate sector. In 1956-57 there were 29,357 companies in total. Of these 74 companies were government companies, 8,771
were public limited and 20,512 were private limited companies. As per latest available figures, from the Department of Company Affairs, Government of India, the total number of companies in 2001-02 had risen to 584,184, almost a twenty-fold increase. Of these, 1262 are government companies. Among these government companies, 659 are public limited or widely held companies and 603 are private limited or closely held companies. Among non-government companies, 75,619 are widely held and 507,303 are closely held companies.

While the bulk of the companies are private limited companies or closely held firms (almost 87 percent), they constitute only about 31 percent of the estimated paid up capital. In fact, if government companies which are closely held are not taken into account, the estimated paid up capital drops further to 19.5 percent. This is indicative of the concentration of capital among the public limited companies or widely held companies and a few government companies. Of the total number companies only a small proportion of these companies are listed on the various stock exchanges. As of 2003, there were 9,644 companies listed across 24 stock exchanges in India. Of these, 7,363 companies were listed on the Bombay Stock Exchange (BSE) and 1,471 companies were listed on the National Stock Exchange.

Business groups in India depict caste and provincial origins. Most of these traditional groups come from the trading communities (e.g. banias) and their initial activities can be traced back to certain parts of the country, although, in more recent times some of the larger groups have assumed a pan-Indian operational character. Groups increased the number of companies under their fold when assets belonging to the erstwhile British companies were acquired.
Traditionally, the management of most of these groups was \textit{via} the \textit{managing agency} system. Under this system, each of the participating firms signs a management contract with a managing agency owned by the group. The \textit{managing agencies} in turn run these firms. Several of the largest business groups in India like the \textit{Tatas} and the \textit{Birlas} were initially run by managing agencies owned by them. However, this system of managing groups has only historical relevance as the \textit{managing agency} system was abolished in 1969 as a consequence of amendments in the statute governing corporations in India.

While firms in India are largely focused entities, the corporate groups tend to be diversified and have certain features similar to a typical western conglomerate or a Japanese \textit{Keiretsu}. Similarities exist in the sense that akin to the headquarters of a conglomerate, the controlling family sets the overall strategic direction and regulates financial transfers. An important difference, though, is that unlike divisions of a typical conglomerate firm, each firm in India has its own unique set of shareholding comprising of various block-holders and the general public.

Group firms in India generally advertise their affiliation to a particular group and these affiliations remain substantially stable over time. Despite the institution of a takeover code in the 1990s the practice of group firms interchanging group affiliations is relatively uncommon. Business groups also differ in the extent and diversity of their operations. The largest groups are active in wide variety of enterprises, ranging from automobile production to educational publishing. They cover vast tracts of the industrial sector and contribute to a significant chunk of the country’s industrial output. On the other hand, the bulk of the business groups can be categorized as small and medium sized, with the scale and scope of their activities being considerably more modest. The firms
constituting business (corporate) groups involve listed as well as unlisted firms. Furthermore, information pertaining to group affiliation is publicly available and it is relatively easy to identify group affiliation with a degree of accuracy in the Indian context. Each firm within a group has a separate legal entity and can be listed separately on the stock exchange. Most groups have less than five firms which are listed on Stock Exchanges such as the BSE. Khanna and Palepu\textsuperscript{20} report 1113 group-affiliated firms listed in various stock exchanges in 1993 in India. The 567 group-affiliated firms which they examined in detail belong to 252 different groups. They find that 95 percent of these groups have five or fewer affiliates.

Apart from the various five-year plans, Industries Development and Regulation (IDR) Act, 1951 and the draconian Monopolistic and Restrictive Trade Practice (MRTP) Act, 1969, The Companies Act, 1956 is the major piece of legislation that impinges on the governance of Indian companies. The Companies Act, 1956 was highly repressive in character and gave the government the ability to control several aspects of corporate policy pertaining to the internal governance of the corporation including the issue of shares and debentures, the appointment and pay of senior management and auditors among others, through a long catalogue of requirements and returns\textsuperscript{21}. Furthermore, the act restricts the transfer of shares in certain cases. For instance, Section 108D (1) of the Companies Act, 1956 states that “Where the Central Government is satisfied that as a result of the transfer of any share or block of shares of a company, a change in the controlling interest of the company is likely to take place and that such change would be prejudicial to the interest of the company or to the public interest, that Government may direct the company not to give effect to the transfer of any share or block of shares...” Several such restrictions in the act coupled with the tendency of the government and the courts to favor incumbent ‘promoters’ results in a largely non-existent market for corporate control. In addition to the Companies Act, 1956,
regulations such as the Securities Contracts Regulation Act 1956, Securities and Exchange Board of India (SEBI) Act 1992 and the Sick Industrial Companies Act (SICA) 1985 also wield considerable influence.

Until the onset of the liberalization process, which began in 1991, the monitoring of corporations was severely constrained on account of a host of factors. Firstly, the market for corporate control was virtually non-existent. Mergers and acquisitions were looked upon by the Monopolies and Restrictive Trade Practices (MRTP) Commission with disfavor, and there were restrictions on the acquisitions and transfer of shares. Financial institutions remained dormant and were instructed by their principal shareholder, the government, not to destabilize existing management. Secondly, a significant proportion of Indian corporations were managed by family members. Professional managers appointed at the highest echelons of the corporate hierarchy were the exception rather than the norm. This blunted the effectiveness of the managerial labor market in being an effective monitoring tool. Thirdly, prior to 1991, the domestic market in India was shielded from competition by a maze of arcane restrictions laid down by the Industries Development and Regulation (IDR) Act, 1951 and very high import tariff barriers. This effectively forestalled any serious competition in the product market. The cumulative effect of this was that family managers remained well entrenched with hardly any accountability on their performance.

The post 1991 time-period marked a dramatic shift in the institutional framework in India. Foreign capital (both direct as well as institutional/portfolio investment) leapfrogged from minuscule levels to form a substantial component of the country’s total capital inflows. In broad terms, foreign direct investments are permitted at a higher level of shareholding. Sector-specific guidelines for consideration of such investments by the Foreign Investment Promotion Board are
stipulated in Annexure 3 and 4 of the New Industrial Policy. These guidelines have been amended from time to time to gradually craft an increasingly open investment ambience. Without going into the specifics of the guidelines it would suffice to mention that automatic approval is granted for a holding of up to 49 percent in most sectors. However, the regulatory regime as far as foreign institutional investment is concerned can be described as more restrictive. In 2000, the shareholding of an individual foreign institutional investor is restricted to a maximum limit of 10 percent of the total issued capital in an individual firm with a cumulative foreign institutional investment limit of 24 percent. This limit can be raised in exceptional circumstances if the board of the domestic company agrees, and it is approved by the central bank, the Reserve Bank of India.

In the ensuing period, the process of financial liberalization and restructuring resulted in the state sponsored financial institutions losing their privileged access to funds from the government and being forced to tap domestic and international markets. This in turn fostered a greater sense of accountability with regard to their monitoring roles in Indian corporations. Within the firms themselves, Indian companies realized the necessity to foster professionalism in their management to remain competitive both in product and financial markets, domestically as well as internationally. This led to a new breed of professional managers at the helm of corporate affairs and the beginnings of a vibrant market for managerial labor. This gradual dismantling of the infamous ‘license raj’ and the progressive reduction in import tariffs ignited the much needed competition in the product market and exposed firms formerly used to a cocooned existence.
3.10  CONCLUSION

In this chapter tax policy, tax reforms and the various internal and external corporate governance mechanisms prevailing in India has been discussed in detail. Various aspects underlying tax reforms in India are also elicited. The corporate tax systems, Chelliah Committee report on tax system and the role of corporate taxation in Indian industries are widely discussed. It is understood that government has brought down the corporate tax rate and surcharge over the period of time in order to increase the industrial growth and turn the foreign investors towards India.
REFERENCES


7. Effective tax rate (ETR) is generally calculated using the following method:
   Effective tax rate for company ‘i’ = tax paid by company ‘i’ / total profit of that company. Effective tax rate for the company group, k = total tax paid by all the companies of that group k/total profit of all the companies of that group. Where PBT is profit before tax, PAT is profit after tax and ‘n’ is the number of companies in group k.


9. Scheduled Tax Rate: corporate tax in India is a fixed percentage of the net profits after allowing for admissible expenses. Scheduled tax rate = corporate tax rate + corporate tax rate × percentage of surcharge.


16. Union Budget, 2001-02


