Chapter VI
SUMMARY AND CONCLUSIONS.

The study has been mainly an empirical exploration of tax impact on dividend behaviour in India. The income tax policy in India has always been discriminatory against dividends. The justification for such a tax policy has been to encourage industrial investment and to make private corporate sector self-sufficient to finance their new ventures.

Though the aim of the tax policy has been clearly set, the designing of the tax tools for the purpose, has not been given due care. Apart from making the income tax system incoherent and complex, the likely tax burden finally borne by dividend incomes has not been properly assessed. For example, the impact of personal taxes was, by and large, overlooked by policy designers for a long time. The rate schedules of personal income tax and capital gains tax were often changed, possibly without taking into account the likely repercussions of such changes on dividend incomes. Further, the dividend taxation was marked by lack of consistency, leading to much confusion and controversy. For example, the closely held companies, unlike the widely held, were encouraged to distribute higher dividends. It is not rare, that some of the public limited companies are treated as 'closely held' for the tax purposes, and therefore, are required to follow a different set of tax laws with respect to their dividend
payments. Furthermore, the tax law was changed too frequently. For example, the laws concerning dividend taxes at the companies' level were subject to major changes too often. The personal income tax rate-schedules and income classifications as well as capital gains tax rules have been changing almost every year.

All this led to a considerable apprehension regarding corporate sector's response to dividend taxation. The private sector and its agencies always have been critical about dividend taxes. But the truth regarding the response remained unknown.

This study attempted at finding the facts in this regard and to provide policy makers with a clearer view of the likely response to their actions in this respect.

1. Summary.

As a first step, the major elements of income tax law relating to corporate dividends over the last three decades since Independence were identified. These are income tax and super tax both at companies' level and shareholders' level, 'penal' dividends tax, 'excess' dividends tax, dividend tax and capital gains tax. Next, the existing literature on dividend behaviour was scanned and empirical studies that concentrated on tax effects on dividends were examined. Unfortunately, in India so far, no study has taken tax effects into account while estimating dividend behaviour models, though there is no dearth of studies on
on dividend behaviour as such. Among the studies pertaining to other countries, those, by Brittain, Feldstein, Moerland and King are important and were examined in detail. The latter three studies based their analysis within a managerial utility maximisation frame. Following these theoretical developments, we assumed that a company has a map of 'utility' indifference curves each denoting a unique level of utility derived by alternative combinations of dividends and retained profits.

The first order conditions of maximisation of the 'utility' function subject to a constraint, namely a profit allocation function, yielded an optimal dividend determination function in which taxes are represented by two variables; a 'tax differential' variable, and a 'tax depression' variable. Basically, the tax differential is the relative opportunity cost of dividend payments per unit cost of retentions. Here the costs are in terms of respective tax burdens. The other way in which dividends are affected by taxation is through the overall depression of profits available by an increase in profits taxes.

Two alternative forms of optimal dividend equation are derived by restricting the shape of the 'utility' function in two ways, a CES form and Cobb-Douglas form. The optimal dividend function was then combined with a dynamic adjustment function to allow for the partial adjustment of actual dividends to 'desired' or 'optimal' dividends in a given year.
The two versions of dividend equation were then fitted to aggregate time-series data published by Reserve Bank of India. The models were estimated by alternative methods to allow for some econometric difficulties associated with such equations. The generalistic CES version of the model did not fit the data properly, as the number of observations (27) were not sufficient. The linear version fitted the data satisfactorily. The analysis was also carried out at disaggregated level by six broad industry groups to bring out the possible differences between companies of different activities, regarding the response to tax policy.

The best of the linear estimated equations were used to quantify the overall tax impact on dividends as well as separately at companies' and shareholders' levels.

The empirical results show that tax differentiation is a very powerful instrument to control corporate dividend decisions in India and the corporate sector is fairly responsive to such policies. This is especially true with manufacturing companies. An important finding is that, contrary to the public impression, the effect of the company dividend taxes was not much. On the other, effect by way of taxing dividends twice, once in the hands of companies and then in shareholders' hands seems to be considerable.
2. Limitations.

The analysis is however, not without limitations. The limitations pertain to all the three stages of the study, namely, specification, data and measurement, and estimation.

Though we tried to specify the dividend behaviour model in as generalistic manner as possible by putting only a minimum set of rational restrictions on the 'utility function', we could not do so. Further restrictions were needed to allow for estimation by linear techniques. The function had to be restricted at least to a CES type. Even then the optimal dividend equation remained 'non-linear' and it could not be estimated with confidence mainly because of insufficient observations. The 'non-linear' version estimated by the Gauss-Newton method and method of steepest descent, therefore could not be used for the simulation exercises. The 'linear' version which we had to stick to, is more restrictive. But, instead of restricting the elasticities to unity apriori, we allowed them to be determined by regression, though in a way it amounts to mis-specification as pointed out by King (1971). Fortunately in our analysis the elasticity estimates do tend to be unities, and the Cobb-Douglas specification seemed to hold in India. Nevertheless, one should also keep in mind that it could also be due to aggregation. The disaggregated estimation by industry groups yielded non-unit elasticities in three out of six groups. But then we cannot altogether dispense with aggregation since, we are not so much concerned
with firm-wise tax impact as with the impact on a conceptually representative company. In other words, we are interested in measuring the average responsiveness in the economy. At the most we are interested in disaggregation only to see if firms in different activities behave differently.

An important limitation had been with regard to the measurement of tax variables. Representing the gamut of personal income tax rates by a single rate has always been a problem in the empirical research in this area, and the results of the analysis are very much dependent on the set of weights chosen for averaging the tax rates. In our study, the weights are based on the shares of dividend incomes falling in different income brackets. But it is well-known that the tax revenue data given in the All India Income Tax Statistics (AIITS) pertain to assessments completed in a given year, rather than assessments relating to that year. Thus the income shares used as weights may be pertaining to a number of past years. In using the AIITS data, one is making an implicit assumption that the proportion of lagged assessments remain constant for all years. Only under that assumption, the weights are valid.

The other limitation pertains to the methods of estimation. The four alternative methods of estimation employed in our study can, perhaps, effectively reduce the inconsistency problem due to serial correlatio
But in so far as the lagged dependent bias is concerned, there is no guarantee that the estimates are not biased.

All these limitations, nevertheless, at best might keep the exact values of the estimates open to doubt. But they might not prevent us from forming broad views as to the extent of tax impact on dividends.

3. Comparison with the past studies.

It would be interesting to see how the findings of our study compare with some of the related studies made in the past, though such comparison is necessarily limited because of differences in specification methodology and other factors.

Among the studies that measured tax impact on dividends, Brittain's model was similar to the linear version used in our analysis. This was in fact an extension of Lintner's equation, in the sense, that instead of a fixed marginal coefficient Brittain specified it as a linear function of tax variable. Our specification based on the Cobb-Douglas type utility function, which restricts the elasticities of income and tax variables to unity, is also similar. But the tax variable 'T' in his analysis denotes only a 'tax shelter' or tax differential at shareholders'level. He does not attempt to take company level tax differential into account. Thus it is comparable to the variable in our analysis. The tax shelter variable in Brittain's study turned-out to be very significant in altering the dividend policies of US companies.
In our study, the generalised version estimated by the Gauss-Newton method also yields a significant elasticity coefficient which is not very different from unity, for the variable $S'$. Later, in our simulation exercises also, personal income tax emerged as a more important factor than company level differentiation caused by dividend taxes.

Feldstein's study of UK experience shows that the impact of changing the tax differential is significant. This is the first study to employ a log-linear type of dividend equation. He takes both company and shareholders' taxes into account and the estimated elasticity of this tax differential variable comes very near to unity, and is very significant. King's work is also on similar lines. He also employs the two versions of dividend equation; the Cobb-Douglas log-linear form and the CES version. But in the Cobb-Douglas equation the elasticity estimates turn out to be non-unities. He therefore, proceeds to estimate the CES version, and obtains an estimate of the elasticity of tax differential to be around 0.6 which is far less than unity. This is quite in contrast with our estimate which is higher than unity.

With regard to the past studies on Indian experience, there are substantial differences between their analysis and ours with respect to the specification. Further, the main focus of our study has been the tax factors while they seldom appeared in other studies. The only common aspect is with respect to the financial factors affecting dividends. Even here, only a general comparison can be made as to which financial factors emerge as significant in the estimated equations.
The most important financial factor hypothesised to affect dividends is investment demand of a company. In India, given the limited scope for external financing, firms mostly depend upon internal savings for financing new ventures. As a result, the investment demand in many of the previous studies emerges as a very important factor affecting dividends. This is also substantiated by our study to a large extent, both in the aggregate as well as industry group-wise estimation. The variables representing growth or growth prospects are also proved to be significant by many studies. In our study also this variable turns out to be important.

4. A policy suggestion.

The study as such is abstained from probing into the ethical aspects of controlling the corporate dividend decision. A mention of the various arguments for and against such controls has already been made in the introductory chapter. To examine whether there is a need for such controls, one should have a perspective much broader than this study, because the need inevitably depends upon the overall objectives of development planning, the investment policy, the incomes policy, and so on. The purpose of this study, on the other, is to objectively measure the corporate response to the government actions in this respect, whichever may be the direction of such actions.

Even so, if one were to take a stand, one is likely to agree with the consensus reached by enquiries such as the Bhoothalingam Committee,
that corporate dividend decisions should be better left outside the purview of government controls. The objectives, namely, raising investment encouraging internal financing and reducing incomes' inequality and conspicuous consumption by dividend receivers, are no doubt desirable, but dividend controls seems to be no answer. For one thing, as proved by past empirical findings, investment, capital structure and dividend decisions are not as much interdependent as one would expect for affecting changes in the former via dividend controls.

The results of our study also partly subscribe to the same view— It shows that investment demand is an important factor affecting dividend policies. But this does not necessarily mean that dividend controls are needed to induce new investment. Whether there are controls or no controls on dividend distributions, companies would have gone for dividend cuts, were there such a necessity. Also in our study, the variable representing capital structure often turned-out to be less compelling, which would mean that artificial reduction of the cost of internal financing is not the main reason for dividend cuts. The effect of the excess dividend taxes, whose objective was explicitly to compel firms to plough back profits, has not proved to be very important. Though this study, by itself, is inadequate to come to any strong conclusions in this respect, if the results are combined with the findings of the past studies, the conclusions inevitably would be the same as above.
The other main objective of dividend restrictions is to reduce incomes' inequality. This argument also proves to be futile when we realise firstly, that the dividend incomes by themselves are not that important to disturb the existing pattern of income distribution. Even if they are so, the ill-effects on incomes' equality can be much more efficiently tackled by monitoring the pattern of new share-issues by companies rather than taxing dividends. Already such controls on share allotments exist. Once such monitoring is ensured, any increase in dividends would be accruing more and more to middle income groups. Further, a rise in dividend rate relative to those on alternative but less productive investments, might as well spread the habit of investing in company shares which might alter the incomes' pattern,

Moreover, there is a need to maintain the freedom of the investors to diversify their investments in more efficient ways. Such an atmosphere will result in the long-run, more efficient allocation of savings in the economy,

All this reasoning points out a need to reduce the present degree of tax differentiation between distributed and undistributed profits, which can be sought in two ways; either by suitably changing the tax system, or by affecting only the rate structure without disturbing the overall system.
Among the income tax systems adopted in the world today, Classical system is no doubt, simpler, more efficient, and administratively less cumbersome, compared to other systems. However, from the point of equity considerations as well as from the point of industrial development, the Classical system is inferior to others such as Imputation or Full-integration systems. Even so, it is not advisable to switch over to the other systems as they definitely involve tedious assessment procedures and consequent delays. Also, the transition from one system to another cannot be expected to be smooth, a point clearly brought out by this study. Therefore, there is no going back from Classical system.

What can be done perhaps, is to reduce the present personal tax rates on dividend incomes. From the revenue point, the tax revenue from this source of income alone is not as much as to upset the government expenditure programs. At present, there already exist certain reductions in the form of straight deductions for dividend incomes. But a more equitable way of reducing the tax burden would be to prescribe a separate rate-schedule for dividend incomes with lower marginal rates.

The 'Schedular' system is not new to India. It existed in the form of separate rate-schedules for 'earned' and 'unearned' incomes. But that system discriminated against 'unearned' incomes which included dividends. More appropriate would have been to prescribe lower tax rates for
dividend incomes. As can be seen in our empirical analysis much of the effect on dividends is due to personal taxes, and the overall sensitivity of companies to such taxes had been rather high. Therefore, reduction of personal marginal rates on dividends will go a long way in contributing to the industrial development, particularly, the manufacturing sector.

Negative methods such as levy of excess dividends taxes at company level are, besides making the tax structure complicated, may not be effective. Positive methods of reducing tax rates on dividends certainly will. The tax reductions will make investments in corporate shares more attractive and will be conducive to the habit of investing in company shares, thereby making more savings available which seem a natural way of increasing the investment rate in the economy. If at all private sector has to be preserved in this country, the best form undoubtedly is the joint-stock corporation with increased public participation.