Chapter I
INTRODUCTION

Private sector has been playing an important role in Indian economy. Its performance over the last three-and-a-half decades since Independence has been impressive both in terms of growth as well as its contribution to the national income. As much as 15 per cent of national income originates in the private organised sector annually. Its annual growth averages to 8 per cent despite two brief recessionary slumps.

The most important organ of production activity in private sector has been joint stock corporation. The modern joint stock corporation, with its capital diffusion and democratic functioning has emerged as the most viable production organ replacing the old Marshallian entrepreneur. Private corporations have been dominating the Indian economic scene for quite some time now. Their growth in terms of capital, though not in numbers, has been steadily increasing. Nearly two-thirds of total capital in the private sector is in the hands of corporations and roughly three-fourths of the output generated in the private sector is by corporations. Their contributions to total savings, capital formation as well as to employment in the economy are by no means negligible.
The mixed economic frame of Indian planning however, assigns only a limited role for private sector, and as such, the size and scope of private corporate activity are constantly monitored by various government controls. The Five-year Plans broadly determine the size of additional investment to take place in private sector in accordance with Plan objectives and also with a view to coordinate the private sector activity with that of public sector. While determining the size of additional capacity the plans also indicate the desirable pattern of the allowed capacity among different industries. Apart from the Plan objectives other social and economic considerations such as reduction of economic inequalities, prevention of creation of monopolies and excess profiteering, as well as stabilising the price level also necessitate regulation of private sector.

The tools employed by government in regulating the corporate activity are numerous and varied. While the direct instruments are in the form of licensing, import-export and foreign regulations, the indirect controls are mainly in the form of credit and tax regulations.

Taxation, particularly income taxation, has been a widely preferred instrument employed to control the private corporate
sector, not only in India, but in many countries. The subtle and persuasive, rather than coercive, nature of taxation offers a wide scope for effective controlling of the free-enterprise sector without disturbing the institutional set-up.

One difficulty in using income taxation as means of regulating corporate activity however, has been the uncertainty regarding the response. Lack of adequate knowledge regarding the corporate response to such tax measures might lead to frequent experimentation with tax laws. Frequent changes in the tax laws in turn, might evoke public apathy and insufficient response. In order to overcome this difficulty the need to collect as much empirical evidence as possible, regarding the degree of tax responsiveness of the corporate sector, can hardly be overemphasised.

Fortunately, there is no dearth of empirical literature in India dealing with corporate behaviour. But much of the literature is primarily concerned with identifying specific behaviour patterns of corporations under changing market conditions and therefore, abstracted from inquiring into the specific tax effects.¹ Studies that took into account taxes, have not gone beyond determining the incidence and shifting of income taxes.² Such polarisation of literature is perhaps, not without reason. Given that the response of corporate sector to taxation depends mainly on the sensitivity of individual
firms to changes in the general market conditions and, their degree of inability to shift away the tax burden, it is only natural to seek information on these aspects and while doing so, concentrating on one aspect at a time. For example, one can expect a high tax response under conditions of zero-shifting and high market sensitivity of firms at least in the short-run. Thus, the information provided by the two groups of studies is certainly of great help to the policy makers. But it would be of greater use if such information is supplemented by some knowledge regarding the extent of market distortions induced by taxes. Studies in this direction are appallingly fewer and necessary academic attention on this aspect is long over due. Alternatively, one might study the resultant total tax response without dissecting into the above component aspects. Such a study may not yield the detailed dissected information, yet, the information will be more complete and useful in designing the tax instruments.

This study is an attempt in this direction. Considering the complex nature of corporate behaviour as a result of numerous management decisions at firm level and the equally diverse tax structure, the study however, is narrowed down to examine the tax impact on only a few aspects of corporate behaviour. In particular, it concentrates on corporate dividend policies.
Among all the corporate decisions few are as important as dividend decision. Dividend decision has implications not only at the level of the individual firms but at the macro economic level as well.

At the individual firm level, dividend is the first, if not the only indicator of a firm's performance. Indeed, the culmination of all the objectives of a modern joint stock company is to generate a steady stream of dividends to its shareholders. Higher and regular dividend payments are sure to enhance the market value of the firm and the reputation of its management. On the other hand, such a policy may mean less availability of internal funds and more dependence on external sources for reinvestment and expansion purposes.

Thus while determining dividend payments, a prudent management strikes a balance between shareholders' preferences and firm's long-term interests while safeguarding their control of the firm.

From the point of view of the economy as a whole, dividend policies of individual firms when added together, play a significant role in determining overall rates of savings and investment as well as patterns of flow of funds in the economy. Further, dividend policies also have other socio-economic implications. If shareholders are concentrated only in a few income brackets, then changes in the dividend incomes will affect the overall incomes' distribution as well as factor shares. Abnormally high dividend payments would...
abnormally low dividend payments under such conditions might lead to less efficient resource allocation in the economy as a result of changed consumption patterns.

Recognising the importance of dividend policies of corporations and their bearing on the resource allocation and income distribution in the economy, it has been a common practice all over the world to regulate such policies. The objectives of such controls, in general, have been to encourage investment activity, to maintain incomes' equality, to reduce conspicuous consumption by shareholders, to control inflation and to maintain reasonable wage-price stability.

Whatever be the objective, the way taxation is used for the purpose is simply to alter the relative tax burden between dividends and retained profits of companies. For example, by raising the relative burden on dividends they can be made 'costlier' for the firms. The differential tax burden can be injected through numerous elements in a tax system either at company level or at shareholders' level. The extent of such tax differentiation as well as the designing of tax system for the purpose, differ from country to country depending upon their specific needs and circumstances. A study made by Organisation for Economic Cooperation and
Devlopment (OECD) has classified the income tax systems according to method of tax differentiation between dividends and retained profits and identified four broad patterns:

At one extreme lies 'Classical system' under which dividends are taxed twice, once in the hands of companies as profits and later in the hands of shareholders as personal incomes. The differential tax burden can reach a maximum under this system. The Classical system is currently followed by countries such as Australia, Denmark, Luxembourg, Netherlands, Spain, Switzerland, and so on. At the other extreme lies the 'Full Integration system' where the differential tax burden is fully neutralised. This system is as utopian as 'pure competition' and is not practised anywhere though attempts are made in Canada, Greece and West Germany. Between these two extremes a number of systems are possible and exist by partially neutralising the differential tax burden. The partial neutralisation is achieved either at company level or at shareholders' level. At company level it is usually effected by following a 'Split rate system' under which distributed profits are taxed at company tax rates different from undistributed profits. This practice is found in Austria, Finland, West Germany, Japan, and Norway. The 'Imputation system' where a credit is given to shareholders for taxes paid at company level is in force in France, Ireland, Italy, United Kingdom, Belgium, and Canada.
8.

In India also over the last three decades, the income tax system contained several elements of tax differentiation aimed at discouraging excessive dividend payments by public limited companies. Till 1959-60, an 'Imputation' type of income tax system was adopted which was replaced later by 'Classical system' and thereby increasing the over-all tax discrimination against dividends. Also from time to time, additional taxes were levied at company level to accentuate the relative tax burden on dividends.

Except for a few passing remarks and scattered comments, the tax differentiation in the income tax system and its associated effects escaped serious academic attention. Whatever writings exist, concentrated only on the additional differentiation caused by way of the occasional levy of excess dividends taxes. A comprehensive analysis of the income tax system from dividends point of view is long overdue. Government's concern for stepping-up of investment and reduction of incomes' inequality is obvious through measures such as excess dividends taxes, discrimination against unearned incomes, or granting tax deductions to dividend incomes and so on. However, such peacemeal attempts might be less effective compared to a longterm consistent tax policy.

Also it should be noted that dividend regulations are not without limitations. It is well-known that investment effort is also a function of demand for it. In the absence of sufficient demand
for new investment, supply side reduction of cost of internal financing will merely result either in a change of pattern of financing through substitution of external sources by internal savings, or in the absence of scope for such substitution, will result in idle holding of funds. Accumulation of idle funds in the hands of a few firms may lead to monopolies and concentration of economic power.

Further, the contention that dividend restraints reduce inflationary forces is based upon the assumption that dividend receivers are concentrated only in top few income brackets, which is not always true. Even if dividend receivers belong to rich income classes it is doubtful that their dividend incomes are completely frittered away in conspicuous consumption. On the contrary, a large portion of dividend incomes might flow back into capital market as new equity and in more efficient directions. Under such conditions dividend regulations will restrict the freedom of investors. This also might lead to a situation where new fast-growing firms are starved of funds.

Furthermore, there is another danger involved, particularly, when such restraints are sought through increasing the tax burden on dividends. Managements of firms, instead of reducing dividends, might actually start paying higher gross dividends to maintain the
net dividend levels which is the very opposite of the objective sought.

In view of these limitations careful administration of this medicine is essential. It also means that even if the creation of tax differential is largely unintentional and only a by-product of a particular tax system designed on the basis of various other considerations such as fuller exploitation of taxable capacity, maintenance of tax equity, keeping the system simple and so on, the economic implications of such differentiation cannot be overlooked.

The present time-series empirical study is an objective attempt to analyse the tax differentiation underlying the Indian income tax system over the last thirty years as well as to measure the response of public limited companies to such differentiation. The purpose being to provide an example of the sensitivity of Indian corporate sector to such regulatory tax measures.

One of the first tasks therefore, is to sift through the numerous tax laws and changes thereof and identify all those elements that caused tax differentiation. Accordingly, the next chapter is devoted to a brief analysis of the relevant aspects of income tax system in India over the study period. In order to facilitate empirical
measurement of likely response, it is important to understand the dividend behaviour in general, and rationalise the way taxes affect the behaviour. Chapter III is therefore devoted to explore the available literature on the subject with a view to assimilate the different thoughts. These different ideas are put together into a model of tax impact on dividend behaviour in Chapter IV to facilitate empirical testing. It also examines the data base and attends to various problems associated with the measurement of different variables. Chapter V deals with the problems of estimation and analyses the results of empirical testing, and finally, Chapter VI presents the conclusions.
Notes and References.


3. Important among these studies are:

4. There are of course, other ways of using taxation to affect dividend restrictions. For example, a general increase in the income taxes both at the company as well as at the shareholders' levels will have a dampening or 'depressing' effect on dividends as it reduces the base to pay dividends. See, Brittain, J.A. (1966). Corporate dividend policy. Studies in Government Finance. The Brookings Institution. Washington D.C. The severity of the depressing effect depends on the reaction of shareholders as well as managements. Such a move on the part of government may or may not result in dividend restraints, but will certainly a blow to the reinvestment efforts by firms. The blow will be severe if the scope for dividend reduction is little.


6. See,
7. See,
(d) Institute of Fiscal Administration. (1970). The multiple burden on dividends and shares by taxation on income and capital of both corporations and shareholders. Amsterdam.