

7. THE TOTAL IMPACT AND INTERNAL GENERATION OF CAPITAL

We have now calculated the estimated change in taxable profits (which we are approximating by using profits before tax as accounted by the respective companies) due to the two major adjustments for inflation—COSA and additional depreciation. The third major adjustment, for gains on net financial liabilities (short-term and long-term), has not been made due to reasons mentioned earlier.

1. **Alternative Ways of viewing the Total Impact**

With the estimates in hand, we can proceed to observe the tax implications and also the implications regarding retained profits. To make the implications clear, we adopt two different methods.

First, we assume that the tax liabilities (approximated by tax provisions) remain the same. Then, we can calculate two effective tax rates, one on the basis of historical cost profits and the other based on adjusted profits. Juxtaposition of these two rates allows us to measure the extent of overtaxation due to inflation.

Alternatively, we assume the same effective tax rate (tax provision divided by historical cost accounts profits) to be applied to inflation-adjusted profits. This yields an estimate of adjusted tax liability on the basis of adjusted profits before tax. A comparison of this with the actual tax provision also yields a measure of over-taxation due to inflation. This comparison implies a comparison of the situation where all the tax rules are based on real values with the present situation.

Under these alternative assumptions about tax liability, we arrive at alternative estimates of profits after tax. From these figures we deduct dividends paid—actuals and, alternatively, those estimated on the basis of a constant pay-out ratio (dividends/profits after tax), to arrive at two alternative estimates of the retained profits (including incentive induced savings). The

investment allowance/development rebate). Assuming the incentive-induced savings to be the same, the amounts of ploughback are estimated.

Tables 7-1.1 to 7-3.4 sum up the results of this exercise. Tables 7-1.1 to 7-1.4 show the adjustments to correct for inflation and also the relative importance of the two adjustments we have undertaken. Tables 7.2.1 to 7.2.4 list the tax provision, adjusted profits after tax, dividends paid, incentive-induced savings and adjusted ploughback under the twin assumptions of constant tax provision and constant dividends for the four price indices. Tables 7.3.1 to 7.3.4 list the same items under the twin assumptions of constant effective tax rate and constant pay-out ratio for the same price indices. The next chapter gives the blown up figures for the whole corporate manufacturing sector indicating the extent of overtaxation of corporate profits.

2. The Total Impact

Table 7.1.1. gives results (complete) for only ten industry groups as COSA was not calculated for groups 1-9 and 20 for reasons given earlier. For the ten industry groups considered, COSA seems to be generally higher than depreciation adjustment in 1979. In the cases of groups 13 and 15 (industry groups 4 and 6, *i.e.*, Textiles. and Ceramic Tiles, Glass and Glass Products, Cement and Asbestos Brake Lining industries), however, it is the other way round.

Losses for two groups (groups 10 and 12) increase after inflation adjustment. For two groups (groups 16 and 18) profits turn into losses. There is no group whose profits go up. The latter two groups, obviously, are most affected by inflation (in terms of percentage reduction in profits). The least affected group is group 15 (Ceramic Tiles, Glass and Glass Products, Cement, and Asbestos Brake Lining). Among the loss-making groups, group 12 (Dairy Products, Grain Mill Products, Sugar and Beer) also pays a heavy toll to inflation, the percentage reduction in profits (increase in losses) being a shade less than that in the case of group 16, which is worst-hit among the profit-making groups. By the same token, however, industry group 1 (group 10, *i.e.*, primary sector companies) is the worst hit of all. The percentage increase in losses is an astronomical

Table 7-1.1

Adjustment for Inflation using Specific Price Indices

(Rs '000)

Group	Unadjusted profits before tax	Total COSA	Total depreciation adjustments	Columns (3/2) percentage	Columns (3+2)/1 percentage	Adjusted profits before tax
	(1)	(2)	(3)	(4)	(5)	(6)
1.	975206.81	—	—	—	—	—
2.	419740.00	—	—	—	—	—
3.	555466.81	—	—	—	—	—
4.	20873.80	—	—	—	—	—
5.	371087.91	—	—	—	—	—
6.	163505.11	—	—	—	—	—
7.	347870.59	—	—	—	—	—
8.	153207.70	—	—	—	—	—
9.	54388.50	—	—	—	—	—
10. (1)	— 30.60	675.39	470.54	—	—	—1176.53
11. (2)	4652.50	3825.40	256.74	82.22	5.52	570.36
12. (3)	—5696.80	20571.84	6242.92	—	—	—32511.56
13. (4)	115356.70	16081.18	39119.04	13.94	33.91	60156.49
14. (5)	202445.00	100104.17	68111.65	49.45	33.64	34229.18

Table 7-1.1 (Contd.)

15. (6)	47895.00	4029.80	16147.80	8.41	33.72	27717.40
16. (7)	4868.20	17509.47	5625.19	359.67	115.54	-18266.46
17. (8)	55727.00	34887.23	13554.54	62.60	24.32	7285.24
18. (9)	26180.00	17165.43	14798.48	65.57	56.53	-5783.91
19. (10)	40321.00	24139.53	9127.25	59.87	22.64	7054.22
20. (11)	63748.80	—	—	—	—	—

Note: (i) Numbers within parentheses represent the industry group.

(ii) For groups 1 to 9 and 20, COSA was not calculated using specific price indices, and hence calculations comparable to other groups cannot be undertaken.

Table 7-1.2

Adjustment for Inflation using the Consumer Price Index

Group	(Rs '000)					
	Unadjusted profits before tax	Total COSA	Total depreciation adjustment	Columns (3/2) percentage	Columns (3+2)/1 percentage	Adjusted profits before tax
	(1)	(2)	(3)	(4)	(5)	(6)
1.	975206.81	92034.00	655558.87	9.44	67.22	227613.94
2.	419740.00	83537.95	478734.66	19.90	114.06	-142532.61
3.	555466.81	8496.04	222245.08	1.53	40.01	324725.69
4.	29873.80	846.21	40813.81	4.05	195.53	-20156.22
5.	371087.91	6774.85	66156.43	1.83	17.83	298156.62
6.	163505.11	874.98	55262.14	0.54	33.80	107367.99
7.	347870.59	6118.88	115483.48	1.76	33.20	226268.23
8.	153207.70	2732.85	40597.46	1.78	26.50	109877.39
9.	54388.50	-355.69	2995.98	-0.65	5.51	51748.21
10. (1)	-30.60	69.33	442.95	—	—	-542.93
11. (2)	4652.50	64.26	195.11	1.38	4.19	4393.13
12. (3)	-5696.96	954.98	5478.22	—	—	-12130.00
13. (4)	115356.70	1832.87	32592.79	1.59	28.25	80931.05
14. (5)	202445.00	6767.63	55639.12	3.34	27.48	140038.25

Table 7-1.2 (Contd.)

15. (6)	47895.00	-147.49	14217.86	-0.31	29.69	33824.63
16. (7)	4868.20	-734.83	4771.17	-15.09	98.01	831.86
17. (8)	55727.00	-164.11	12176.02	-0.29	21.85	43715.10
18. (9)	26180.00	191.76	13230.79	0.73	50.54	12757.46
19. (10)	40321.00	-189.47	7582.26	-0.47	18.80	32928.21
20. (11)	63748.80	-84.15	11181.73	-0.21	17.54	52651.21

Table 7-1.3
Adjustment for Inflation using the General Wholesale Price Index

Group	(Rs '000)					
	Unadjusted profits before tax	Total COSA	Total depreciation adjustments	Columns (3/2) percentage	Columns (3+2)/1 percentage	Adjusted profits before tax
	(1)	(2)	(3)	(4)	(5)	(6)
1.	975206.81	1807770.50	735508.00	185.37	75.42	-1568071.75
2.	419740.00	1407207.50	535569.56	335.26	127.60	-1523037.12
3.	555466.81	400563.00	183479.45	72.11	33.03	-28575.64
4.	20873.80	96846.28	44106.52	463.96	211.30	-120079.00
5.	371087.91	238779.64	74754.95	64.35	20.14	57553.31
6.	163505.11	74937.06	64554.42	45.83	39.48	24013.63
7.	347870.59	293048.12	125524.20	84.24	36.08	-70701.73
8.	153207.70	70718.07	49431.73	46.16	32.26	33057.90
9.	54398.50	36796.78	3651.80	67.66	6.71	13939.92
10. (1)	-30.60	581.02	488.52	-	-	-1100.07
11. (2)	4652.50	1257.96	249.56	27.04	5.36	3144.98
12. (3)	-5696.80	18871.21	6086.14	-	-	-30654.15
13. (4)	115356.70	101269.65	36131.62	87.79	31.32	-22044.57
14. (5)	202445.00	118197.00	65734.63	58.38	32.77	18513.37

Table 7-1.3 (Contd.)

15. (6)	47895.00	9638.19	15864.18	20.12	33.12	22392.63
16. (7)	4868.20	20372.00	5329.22	418.47	109.47	-20833.08
17. (8)	55727.00	41622.27	13231.55	74.69	23.74	873.18
18. (9)	26180.00	22105.12	14532.41	84.44	55.51	-10457.53
19. (10)	40321.00	26335.90	8481.56	65.32	21.04	5503.54
20. (11)	63748.80	31569.52	12620.08	49.52	19.80	19559.21

Table 7-1.4

Adjustment for Inflation using the Implicit GNP Deflator

Group	(Rs '000)					
	Unadjusted profits before tax	Total COSA	Total depreciation adjustments	Column (3/2) percentage	Column (3+2)/1 percentage	Adjusted profits before tax
	(1)	(2)	(3)	(4)	(5)	(6)
1.	975206.81	296206.59	619856.94	30.37	63.56	59143.28
2.	419740.00	219911.17	456783.00	52.39	108.82	-256954.17
3.	555466.81	71215.45	154929.62	12.82	27.89	329321.72
4.	20873.80	17409.75	38346.94	83.40	183.71	-34882.89
5.	371087.91	43912.10	62432.74	11.83	16.82	264743.06
6.	163505.11	14893.59	54046.05	9.11	33.05	94565.46
7.	347870.70	55844.53	109562.41	16.05	31.50	182463.66
8.	153207.70	12359.35	39053.05	8.07	25.49	101795.30
9.	54388.50	8011.57	2647.22	14.73	4.87	43729.72
10. (1)	-30.60	70.05	401.71	—	—	-502.35
11. (2)	4652.50	205.94	157.51	4.43	3.39	4289.05
12. (3)	-5696.80	3097.42	5190.88	—	—	-13985.10
13. (4)	115356.70	19548.81	32180.87	16.95	27.90	63627.02
14. (5)	202445.00	20692.35	52820.05	10.22	26.09	128932.60

Table 7-1.4 (Contd.)

15. (6)	47895.00	1646.78	13475.06	3.44	28.13	32773.16
16. (7)	4868.20	1529.70	4590.49	31.42	94.30	-12.51.99
17. (8)	55727.00	8350.40	11502.45	14.98	20.64	35874.15
18. (9)	26180.00	4452.79	12761.52	17.01	48.75	8965.69
19. (10)	40321.00	5666.09	7213.48	14.05	17.89	25441.43
20. (11)	63748.80	6626.96	9985.72	10.40	15.66	47136.12

Now let us examine the results given in Table 7-1.2. When the consumer price index is used, only government companies are affected by inflation through COSA more than through depreciation adjustment. After adjustment for inflation, their profits turn into losses. This is not so for non-government companies as a whole. Among them, however, the smallest sized companies seem to be worst affected by inflation, their profits turning into losses after adjustment. Among the other two size-groups, the impact of inflation seems to be greater on the largest companies. As for the three age-groups, the oldest companies are the most affected and the new companies are the least affected, with negative COSA, and very little depreciation adjustment.

Among the industry groups, the least affected is group 11 (industry group 2, *i.e.*, Fuel, Power, Light and Lubricants). COSA is negative for many of the industry groups. The worst affected is group 10, with its losses going up by an astounding 1674 per cent. It may be noted that we arrived at a similar result using specific price indices. Group 16 loses about 83 per cent of its profits after adjustment, which is the highest impact of inflation among the profit-making industry groups.

Table 7-1.3 paints quite a different picture. The corporate manufacturing sector as a whole, and both government and non-government companies in the aggregate, are shown to be incurring losses when adjustment for inflation is undertaken. Government companies are comparatively hard-hit with unadjusted profits going down by about 463 per cent. Among the size-groups within non-government companies, the smallest companies are the worst affected with profits going down by 675 per cent. The other two size-groups are affected to a marginally smaller extent. Among the age-groups, the oldest companies become loss-making companies after adjustment, whereas the other two groups lose about 75 per cent of their profits.

As for the industry groups, group 10 again loses most in the adjustment of profits and the least adjustment is for group 11. Three of the nine profit-making groups go into the red after adjustment. Among the profit-making groups, 16 is again the most affected.

The relative effect of inflation on various groups, as revealed by Table 7-1.4, is quite similar to that revealed by

Table 7-1.2, although the COSA is higher in all cases. The government companies and the smallest companies in the private sector show losses instead of profits after adjustment for inflation. Among the three size-groups, the middle size-group is least affected by inflation as the adjustment for inflation is the least in terms of percentage reduction in profits. The impact of inflation on profits is again inversely related to size, as revealed by the results for the three age-groups. As far as the industry groups are concerned, the pattern is once again the same, except that the use of the implicit GNP deflator results in lower adjusted profits in all the cases; in one case (group 16) profits turn into losses, which does not happen when the CPI is used.

3. Constant Tax Liability

Tables 7-2.1 to 7-2.4 paint a very gloomy picture of inflation-adjusted profits and ploughback. Taking Table 7-2.1 first, we see that only two industry groups have positive profits after tax. Ploughback, either net of tax-induced savings or gross of them, is negative for all the industry groups, implying continuous erosion of capital. Since profits after tax are negative in most cases, it is obvious that the adjusted effective tax rate (actual tax provision/adjusted profits before tax) is generally greater than one hundred per cent. In the two cases that it is not, the adjusted effective tax rate is nevertheless very high. Four of the ten industry groups analysed have negative profits before tax, and so their negative post-tax profitability is not due to the tax. With two industry groups having small but positive post-tax profits, in the cases of four industry groups taxes are responsible for turning profits into losses.

The picture presented in Table 7-2.2 is not all that gloomy. For the corporate manufacturing sector as a whole, adjusted post-tax profits are negative, but though the government companies show huge losses, the non-government ones show a small profit. Among the broad sub-groups of non-government companies, only group 4 (the smallest-sized companies within the sample) shows post-tax losses. Their losses are not caused by taxes, however, as their pre-tax profits are also negative. Among the industry groups, only one (group 16) goes into the red due to taxes.

Ploughback, net of tax incentive induced savings, is positive

Table 7-2.1

Post-Tax Profits under the Assumption of Constant Tax Provision and Dividends using Specific Price Indices

(Rs '000)

<i>Group</i>	<i>Tax provision</i>	<i>Adjusted profits after tax</i>	<i>Dividends</i>	<i>Tax induced savings</i>	<i>Net plough-back</i>
	(1)	(2)	(3)	(4)	(5)
1.	—	—	—	—	—
2.	—	—	—	—	—
3.	—	—	—	—	—
4.	—	—	—	—	—
5.	—	—	—	—	—
6.	—	—	—	—	—
7.	—	—	—	—	—
8.	—	—	—	—	—
9.	—	—	—	—	—
10. (1)	0.00	—1176.50	459.00	30.60	—1666.1
11. (2)	2540.00	—1969.64	1074.20	222.00	—3265.8
12. (3)	16.80	—32528.37	1596.20	1621.90	—35746.5
13. (4)	58885.00	1270.59	22941.40	19310.20	—40981.0
14. (5)	74238.50	—40009.32	21684.10	23962.50	—85655.9
15. (6)	22282.80	5434.60	11364.40	4809.40	—10739.2
16. (7)	4885.70	—23152.16	3423.00	2082.50	—28657.7
17. (8)	37189.10	—29903.87	10211.10	3447.40	—43562.4
18. (9)	10600.70	—16384.61	6064.90	1395.50	—23845.0
19. (10)	25960.00	—18905.78	5290.60	4219.00	—28415.4
20. (11)	—	—	—	—	—

Note: COSA calculations could not be carried out for groups 1-9 and 20 using specific price indices; hence further calculations for these groups were precluded.

Table 7-2.2

Post-Tax Profits under the Assumption of Constant Tax Provision and Dividends using the Consumer Price Index

(Rs '000)

<i>Group</i>	<i>Tax provision</i>	<i>Adjusted profits after tax</i>	<i>Dividends</i>	<i>Tax induced savings</i>	<i>Net plough-back</i>
	(1)	(2)	(3)	(4)	(5)
1.	726339.89	—498725.97	238423.00	331965.00	—1069113.9
2.	460215.20	—602747.81	137114.80	262559.00	—1002421.6
3.	266124.69	58600.99	101308.20	69406.00	—139113.2
4.	36960.30	—57116.52	15433.60	12413.20	—84963.3
5.	163464.40	134692.22	58879.10	50749.70	25063.4
6.	65700.00	41667.99	26995.50	6243.10	8429.4
7.	171938.50	54329.74	79288.90	48320.10	—73279.3
8.	54028.10	55849.29	11058.20	7510.10	37281.0
9.	40158.10	11590.12	10961.10	13575.80	—12946.8
10. (1)	0.00	—542.93	459.00	30.60	—1032.5
11. (2)	2540.00	1853.13	1074.20	222.00	556.9
12. (3)	16.80	—12146.80	1596.20	1621.90	—15364.9
13. (4)	58885.90	22045.15	22941.40	19310.20	—20206.5
14. (5)	74238.50	55799.76	21684.10	23962.50	10153.2
15. (6)	22282.80	11541.83	11364.40	4809.40	—4632.0
16. (7)	4885.70	—4053.84	3423.00	2082.50	—9559.3
17. (8)	37189.10	6526.00	10211.10	3447.40	—7132.5
18. (9)	10600.70	2156.75	6064.90	1395.50	—5303.7
19. (10)	25960.00	6968.21	5290.60	4219.00	—2541.4
20. (11)	29525.20	23126.02	17199.30	8305.00	—2378.3

Table 7-2.3

Post-Tax Profits under the Assumption of Constant Tax Provisions and Dividends using the General Wholesale Price Index

(Rs '000)

<i>Group</i>	<i>Tax provision</i>	<i>Adjusted profits after tax</i>	<i>Dividends</i>	<i>Tax induced savings</i>	<i>Net plough-back</i>
	(1)	(2)	(3)	(4)	(5)
1.	726339.89	—2294411.50	238423.00	331965.00	—2864799.5
2.	460215.20	—1983252.25	137114.80	262559.00	— 2382926.1
3.	266124.69	—294700.34	101308.20	69406.00	—465414.5
4.	36960.30	—157039.30	15433.60	12413.20	—184886.1
5.	163464.40	—105911.09	58879.10	50749.70	— 215539.9
6.	65700.00	—41686.37	26995.50	6243.10	—74925.0
7.	171938.50	—242640.22	79288.90	43320.10	—370249.2
8.	54028.10	—20970.20	11058.20	7510.10	—39538.5
9.	40158.10	—26218.18	10961.10	13575.80	—50755.1
10. (1)	0.00	—1100.07	459.00	30.60	—1589.7
11. (2)	2540.00	604.98	1074.20	222.00	—691.2
12. (3)	16.80	—30670.96	1596.20	1621.90	—33889.7
13. (4)	58885.90	—80930.47	22941.40	19310.20	—123182.1
14. (5)	74238.50	—55725.13	21684.10	23962.50	—101371.7
15. (6)	22282.80	109.83	11364.40	4809.40	—16064.0
16. (7)	4885.70	—25718.78	3423.00	2082.50	—31224.3
17. (8)	37189.10	—36315.92	10211.10	3447.40	—49974.4
18. (9)	10600.70	—21058.23	6064.90	1395.50	— 28518.6
19. (10)	25960.00	—20456.46	5290.60	4219.00	—29966.1
20. (11)	29525.20	—9966.00	17199.30	8305.00	—35470.3

Table 7-2.4

Post-Tax Profits under the Assumption of Constant Tax Provision and Dividends using the Implicit GNP Deflator

(Rs '000)

<i>Group</i>	<i>Tax provision</i>	<i>Adjusted profits after tax</i>	<i>Dividends</i>	<i>Tax induced savings</i>	<i>Net plough-back</i>
	(1)	(2)	(3)	(4)	(5)
1.	726339.89	- 667196.62	238423.00	331965.00	-1237584.6
2.	460215.20	-717169.37	137114.80	262559.00	-1116843.1
3.	266124.69	63197.04	101308.20	69406.00	-107517.2
4.	36960.30	-71843.20	15433.60	12413.20	- 99690.0
5.	163464.40	101278.66	58879.10	50749.70	8350.1
6.	65700.00	28865.46	26995.50	6243.10	-4373.1
7.	171938.50	10525.15	79288.90	48320.10	-117083.9
8.	54028.10	47767.20	11058.20	7510.10	29198.9
9.	40158.10	3571.62	10961.10	13575.80	-20965.3
10. (1)	0.00	- 502.35	459.00	30.60	-992.0
11. (2)	2540.00	1749.05	1074.20	222.00	452.9
12. (3)	16.80	-14001.90	1596.20	1621.90	-17220.0
13. (4)	58885.90	4741.12	22941.40	19310.20	-37510.5
14. (5)	74238.50	54694.11	21684.10	23962.50	9047.5
15. (6)	22282.80	10490.36	11364.40	4809.40	-5683.4
16. (7)	4885.70	- 6137.69	3423.00	2082.50	-11643.2
17. (8)	37189.10	-1314.95	10211.10	3447.40	-14973.5
18. (9)	10600.70	-1635.01	6064.90	1395.50	-9095.4
19. (10)	25960.00	481.43	5290.60	4219.00	-9028.2
20. (11)	29525.20	17610.92	17199.30	8305.00	-7893.4

for five groups out of the twenty. The most notable fact in this result is that the two larger size-groups manage to divert part of their adjusted profits into the company, but not the smallest ones within the sample. Considering ploughback gross of tax incentive induced savings, four additional groups come into the positive ploughback group. Government companies as well as non-government companies, each group as a whole, have negative ploughback either way. But the two groups of comparatively large companies, and the two groups of comparatively new companies are shown to have positive gross ploughback. Thus, in the non-government corporate manufacturing sector, the smallest and the oldest companies are shown to have done badly, after the adjustment for inflation. Among the industry groups, two (groups 11 and 14) exhibit positive net ploughback, and they and three more (15, 19 and 20) exhibit positive gross ploughback.

Use of the general wholesale price index (Table 7-2.3) leads to a dismaying picture, with adjusted profits after tax negative in all but two cases, both of which are industry groups. Ploughback, gross or net of tax incentive induced savings, is negative in all cases. Dwelling on these results group-wise is not very useful, because it is clear that the situation is bad. Differences are only in degree.

Use of the GNP deflator (Table 7-2.4) yields a slightly better picture. The scenario is more or less the same as in the case of Table 7-2.2 (results of the use of consumer price index), except that two industry groups (groups 17 and 18) exhibit losses after tax whereas in the other case they showed profits. Net ploughback is negative in this case, whereas it was positive in Table 7-2.2, for group 6, *i.e.*, the largest size-group. Group 6, however, exhibits positive gross ploughback, along with group 20. Three groups which showed positive gross ploughback in Table 7-2.2 do not show a similar result in Table 7-2.4

Thus, overall, use of the consumer price index shows the least depressing picture, whereas use of the general wholesale price index shows the most depressing one. Results for only ten groups are derived using the specific price indices, but they do not show the situation to be as bad as in Table 7-2.3.

All the results, taken together, allow us to draw some broad

3.1. Implications

First, it appears that the impact of inflation has been quite severe upon all the companies, but in varying degrees across groups and also depending upon the price index being used. In our calculations, the use of the general wholesale price index causes the maximum reduction in profits, but that is true only for the year 1979. It is quite possible that if similar calculations were done for another year, the same conclusion might not hold. Thus, no systematic relation can be postulated between the extent of inflation adjustment and the choice of the price index used, based only on our calculations. But since the relative positions of different groups do not change all that much with the change in the price index used, perhaps these differences are more systematic. Government companies are shown to become much less profitable than non-government ones, once adjustment for inflation is made. Among the non-government companies the smaller companies and the older companies seem to show profits largely because no adjustment for inflation is made. Once it is done, the profits tend to turn into losses.

It seems that with inflation accounting, a large number of manufacturing companies will have no profits and hence no tax liability. A large part of the total tax provisions, it seems, can be traced to lack of adjustment for inflation, which causes conventionally calculated profits to swell, without any corresponding increase in real profits. Also, it is obvious that very few companies could actually afford the dividends that they paid; the payment of dividends was only at the cost of erosion of capital base. The implication is that but for inflation and the consequent overtaxation and overpayment of dividends,¹ the number of times the companies went to the capital market for loans or with fresh issues would have been much less. In real terms, expansion has obviously been financed by external funds rather than internally generated funds. But taxation is to be blamed only partially for this; as our results show, adjusted

¹Dividends have been overpaid in the sense that the companies could not afford them in general. However, there are various other factors which affect dividends. These may even force a company to pay dividends when

profits before tax are negative for many groups; strictly speaking they should not have paid dividends.

4. Constant Effective Tax Rate

Tables 7-3.1 to 7-3.4 also show the impact of inflation on profits as Tables 7-2.1 to 7-2.4, but under the twin assumptions that the effective tax *rate* and the pay-out ratio are constant. The figures for tax provision and dividends are, thus, estimates. The figures for tax incentive induced savings are, however, actuals. Whenever profits before tax are negative for a group, tax provisions are assumed to be zero. Similarly, wherever profits after tax are negative, dividends are assumed to be zero. In one case (Table 7-3.2, group 16), though profits after tax are positive, they are so small that we have treated them as zero. It is of course possible that even when a company is making a loss, it may pay dividends, but here we have estimated dividends entirely on the basis of a constant pay-out ratio and profits after tax, to see what would have been the situation if the companies had decided to keep dividends within the available funds (in real terms) generated during the year. The results for each group have to be examined separately because tax provision and dividends are estimated for each group separately. Though some groups are only sub-groups of a broader group, the estimates are not consistent for that reason. Also, estimated tax provision figures do not include tax provision for the earlier years, which, however, are deducted (unadjusted) from the profits before tax (adjusted) along with the adjusted tax provision to arrive at the adjusted profits after tax.

The assumptions made ensure (except in the unlikely case of effective tax rate being higher than unity) that the groups which have positive adjusted profits before tax also have positive adjusted profits after tax. Similarly, those groups which have positive adjusted profits after tax also have positive gross ploughback.

Taking Table 7-3.1 first, one finds that profits after tax are negative for four of the ten industry groups. Net ploughback, however, is negative for all the groups except one (group 15). This is, as can be seen, because the tax incentive induced savings are quite small for group 15 compared to its profits, relative to

Table 7-3.1

Post-Tax Profits under the Assumption of Constant Tax Rate and Pay-out Ratio using Specific Price Indices

(Rs '000)

<i>Group</i>	<i>Adjusted tax provision</i>	<i>Adjusted profits after tax</i>	<i>Adjusted dividends</i>	<i>Tax induced savings</i>	<i>Plough-back</i>
	(1)	(2)	(3)	(4)	(5)
1.	—	—	—	—	—
2.	—	—	—	—	—
3.	—	—	—	—	—
4.	—	—	—	—	—
5.	—	—	—	—	—
6.	—	—	—	—	—
7.	—	—	—	—	—
8.	—	—	—	—	—
9.	—	—	—	—	—
10. (1)	0.00	—1176.53	0.00	30.60	—1207.13
11. (2)	311.42	258.94	131.54	222.00	—94.60
12. (3)	0.00	—32511.56	0.00	1621.90	—34133.46
13. (4)	30439.18	29191.40	11851.71	19310.20	—1970.51
14. (5)	12767.48	22824.20	3857.29	23962.50	—4995.59
15. (6)	12583.70	14604.90	6484.58	4809.40	3310.92
16. (7)	0.00	—18266.46	0.00	2082.50	—20348.96
17. (8)	5085.09	3906.64	2152.56	3447.40	—1693.32
18. (9)	0.00	—5783.91	0.00	1395.50	—7179.41
19. (10)	4542.92	2511.30	924.16	4219.00	2631.86
20. (11)	—	—	—	—	—

Note: Since COSA calculations could not be carried out for groups 1-9

Table 7-3.2*Post-tax Profits under the Assumption of Constant Tax Rate and Pay-out Ratio using the Consumer Price Index**(Rs '000)*

<i>Group</i>	<i>Adjusted tax provision</i>	<i>Adjusted profits after tax</i>	<i>Adjusted dividends</i>	<i>Tax induced savings</i>	<i>Plough-back</i>
	(1)	(2)	(3)	(4)	(5)
1.	162288.73	34768.00	33307.74	331965.00	—330504.74
2.	0.00	—142532.61	0.00	262559.00	—405091.61
3.	156517.78	169865.91	59453.07	69406.00	41006.84
4.	0.00	—20156.22	0.00	12413.20	—32569.86
5.	133872.33	167285.70	47509.14	50749.70	69026.86
6.	43161.93	64206.06	17720.87	6243.10	40242.09
7.	113134.12	115077.92	51900.14	48320.10	14857.68
8.	38127.45	70918.23	7871.92	7510.10	55536.21
9.	33707.67	13586.45	10461.57	13575.80	—10450.92
10. (1)	0.00	—542.93	0.00	30.60	—573.53
11. (2)	2398.65	1994.48	1013.20	222.00	759.28
12. (3)	0.00	—12130.00	0.00	1621.90	—13751.90
13. (4)	40951.11	39454.04	16018.34	19310.20	4125.50
14. (5)	52234.27	39166.48	15069.14	23962.50	134.84
15. (6)	15356.38	17939.45	7965.12	4809.40	5164.93
16. (7)	837.69	12.48	0.00	2082.50	—2070.02
17. (8)	30513.14	14908.46	8214.56	3447.40	3246.50
18. (9)	5370.89	7808.37	3037.45	1395.50	3375.42
19. (10)	21205.77	11722.44	4313.86	4219.00	3189.58
20. (11)	23745.70	28109.12	14138.89	8305.00	5665.23

Table 7-3.3

Post-Tax Profits under the Assumption of Constant Tax Rate and Pay-out Ratio using the General Wholesale Price Index

(Rs '000)

<i>Group</i>	<i>Adjusted tax provision</i>	<i>Adjusted profits after tax</i>	<i>Adjusted dividends</i>	<i>Tax induced savings</i>	<i>Plough-back</i>
	(1)	(2)	(3)	(4)	(5)
1.	0.00	-1568071.75	0.00	331965.00	-1900036.75
2.	0.00	-1523037.12	0.00	262559.00	-1785596.12
3.	0.00	-28575.64	0.00	69406.00	-97981.64
4.	0.00	-120079.00	0.00	12413.20	-107666.20
5.	25841.44	34713.27	9858.57	50749.70	-25895.00
6.	9653.48	14360.15	3963.40	6243.10	4153.65
7.	0.00	-70701.73	0.00	48320.10	-119021.83
8.	11471.09	20755.11	2303.82	7510.10	10941.19
9.	10427.06	4058.76	3125.25	13575.80	-12642.29
10. (1)	0.00	-1100.07	0.00	30.60	-1130.67
11. (2)	1717.16	1427.82	725.33	222.00	480.49
12. (3)	0.00	-30654.15	0.00	1621.90	-32276.05
13. (4)	0.00	-22044.57	0.00	19310.20	-41354.77
14. (5)	6905.49	12970.38	2191.99	23962.50	-13184.11
15. (6)	10166.26	11697.58	5193.73	4809.40	1694.45
16. (7)	0.00	-20833.08	0.00	2082.50	-22915.58
17. (8)	609.48	1970.20	1085.58	3447.40	-2562.78
18. (9)	0.00	-10457.53	0.00	1395.50	-11853.03
19. (10)	3544.28	1959.26	721.01	4219.00	-2980.75
20. (11)	8821.20	9941.60	5000.63	8305.00	-3364.03

Table 7-3.4

Post-Tax Profits under the Assumption of Constant Tax Rate and Pay-out Ratio using the Implicit GNP Deflator

(Rs '000)

<i>Group</i>	<i>Adjusted tax provision</i>	<i>Adjusted profits after tax</i>	<i>Adjusted dividends</i>	<i>Tax induced savings</i>	<i>Plough-back</i>
	(1)	(2)	(3)	(4)	(5)
1.	42169.16	—13583.08	0.00	331965.00	—345548.08
2.	0.00	—256954.17	0.00	262559.00	—519513.17
3.	158733.08	172246.66	60286.33	69406.00	102840.66
4.	0.00	—34882.89	0.00	12413.20	—47296.09
5.	118869.63	146874.83	42280.45	50749.70	55844.68
6.	38015.32	56550.15	15607.84	6243.10	34699.21
7.	91231.83	93175.62	42022.21	48320.10	2833.31
8.	35322.97	65640.63	7286.11	7510.10	50844.42
9.	32709.83	11565.79	8905.66	13575.80	—10915.67
10. (1)	0.00	—502.36	0.00	30.60	—532.96
11. (2)	2341.82	1947.23	989.19	222.00	736.04
12. (3)	0.00	—13985.10	0.00	1621.90	—15607.00
13. (4)	32195.27	30905.85	12547.77	19310.20	—952.12
14. (5)	48091.86	82203.24	13982.35	23962.50	44348.39
15. (6)	14879.02	17365.35	7710.21	4809.40	4845.74
16. (7)	0.00	—1251.99	0.00	2082.50	—3334.49
17. (8)	25040.16	12540.49	6909.81	3447.40	2183.28
18. (9)	3774.55	5612.93	2183.43	1395.50	2034.00
19. (10)	17028.28	9413.15	3464.04	4219.00	1730.11
20. (11)	21258.39	25081.33	12615.91	8305.00	4160.41

tive induced savings) is much higher for, say, group 14 compared to its profits, but net ploughback is not. Of course, the fact remains that most of these tax incentive induced savings cannot be used by the company for dividend payments until a specified amount of time elapses, but the positive dividend payments could have been financed by loans which were repaid (along with interest) from the reserves created from these tax incentive induced savings. In any case, forcing a company to save rather than pay dividends implies a similar compulsion to generate funds internally instead of externally if the impact of dividend payments is higher than that of savings on the capacity to raise share capital. Theoretically, such a situation is inexplicable, but so is the fact that despite the ability to pay shareholders through capital gains which is taxed at a lower rate in the hands of individuals, the companies keep paying dividends instead of retaining profits.

As can be seen in Table 7-3.2, profits for the corporate manufacturing sector as a whole are small but positive, most of which are paid out as dividends, leaving a small amount of gross ploughback. But tax incentive-induced savings being much higher, net ploughback is negative. Government companies as a group make a loss after adjustment for inflation, and by assumption there is no tax provision or dividends. With a fairly high amount of tax incentive induced savings, the net ploughback is negative and quite large. The implications are obvious. The non-government companies as a whole fare better. Profits after tax are positive, and even after payment of dividends, both gross and net ploughbacks are positive, indicating a certain amount of internal generation of funds. The same is true for the subgroups of the non-government companies also, with the exception of the smallest companies and the newest companies within the sample. The smallest companies make a loss after adjustment for inflation, and so their gross as well as net ploughbacks are negative. The newest companies, however, exhibit positive gross ploughback, but negative net ploughback, implying a forced reliance on internally generated funds.

Among the industry groups, only three exhibit negative ploughback, out of which two make losses after adjustment (groups 10 and 12). The third (group 16) makes a very small profit.

The performance of most of the broad groups and sub-groups concerned in Table 7-3.3 is dismal. Among the first nine groups only four have positive profits (groups 5, 6, 8 and 9), and hence positive gross ploughback. But net ploughback is negative for two of them (groups 5 and 9) as well as for all the other five groups (those having negative profits). Only the middle size-group companies and the 11-20-year-old companies exhibit positive ploughback. Among the industry groups, six out of eleven (groups 11, 14, 15, 17, 19 and 20) have positive profits after tax and hence after dividends, but net ploughback is negative for four of them (groups 14, 17, 19 and 20).

Examining Table 7-3.4 now, we find that the corporate manufacturing sector as a whole makes losses after tax, making both gross and net ploughback negative. But it is the government companies which cause this to happen in the aggregate as the results for groups 2 and 3 clearly show. Considering the sub-groups of the non-government companies, the results are similar to those in Table 7-3.2. For the industry groups also, the results are similar except for two differences. In the case of group 13, the net ploughback is negative, whereas it was positive for the same group in Table 7-3.2. The small profits after tax of group 16 turn into losses in Table 7-3.4.

4.1 Implications

The broad conclusions that can be drawn are exactly the same as in the case of the results presented in Tables 7-2.1 to 7-2.4. In section 4 above we attempted to find out what the situation would be if the income tax rules permitted the two major adjustments we carried out keeping other things the same, and if companies paid dividends at certain rates from disposable profits. The results broadly indicate that in such a situation, capital erosion would have taken place in some groups. The cause, evidently, is poor real profitability and in this respect the government companies fare very badly. Inflation accounting should, it seems, be insisted upon, if only to shatter the myth of profitability of many companies when they are making losses in real terms.

Having said all this, a note of caution is perhaps necessary. As pointed out earlier, our adjustment calculations exclude the adjustments for net financial liabilities. Under conditions of

inflation, the adjustment in profits for positive net financial liabilities would be upwards. And manufacturing companies are likely to have a substantial amount of net financial liabilities. The adjustments for these would cancel to some extent those for depreciation and inventory. Such adjustments would vary directly with the size of net financial liabilities and the proportion of old debts in them. How important they would be is a question that is empirical in nature and can be answered only if the necessary calculations are undertaken.