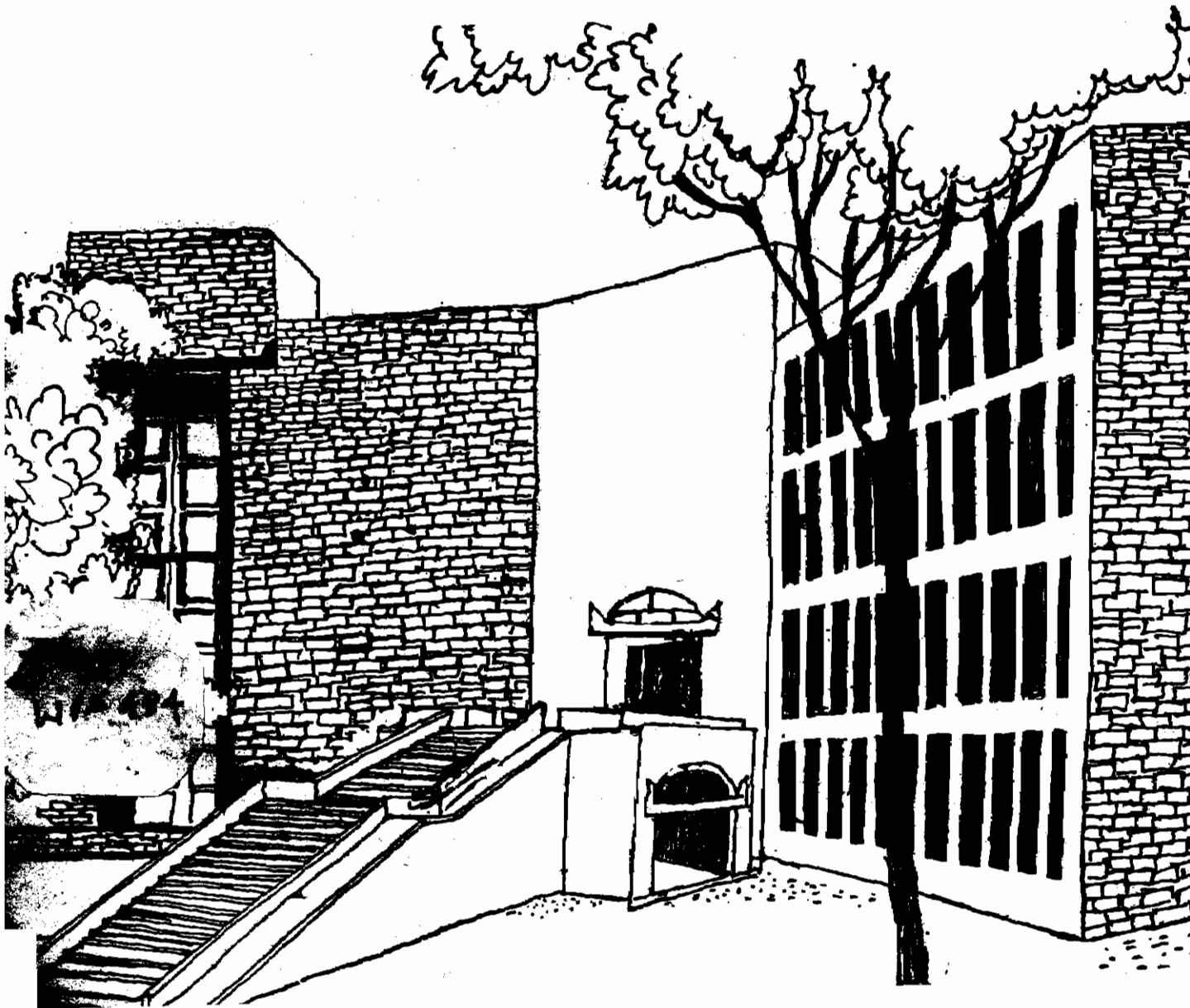




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Working Paper



A CASE FOR DISALLOWING INTEREST
DEDUCTIBILITY AND REDUCING
CORPORATE TAX RATE

By

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ABSTRACT

The tax deductibility of interest cost seems to be the major reason for the existing very high level of corporate borrowings in India. It is therefore suggested in this paper that interest cost may be disallowed as a deductible expense and simultaneously, the corporate tax rate may also be reduced in a way that not only the corporate sector's tax burden remains unaltered but also the government does not suffer any loss of tax revenue. In view of the existing corporate tax rate of 60% and interest to profits before interest and taxes ratio of 40%, the proposed tax rate can, thus, be fixed at 36%, disallowing the interest deductibility.

The proposed change would cause reallocation of the aggregate tax burden among companies. Thus, although the corporate sector's aggregate tax burden would not change yet individual companies would be affected favourably or adversely. All profitable nonlevered companies would gain, saving 24% of profits as tax, by the change. The highly profitable levered companies, whose rates of return exceed two and a half times of their interest rates, would benefit more than the profitable nonlevered companies. The moderately profitable levered companies, whose rate of return are in excess of two and a half times of their interest rates into debt ratios, would also gain but less than the profitable levered companies.

The less or marginally profitable levered companies would lose (they will have to pay more taxes) on account of the proposed change. Maximum loss will be suffered by the companies with low profitability and high leverage. Loss-making existing and new companies and sick companies would not be affected immediately as they do not incur any tax liability, but they would suffer when they would become profitable in the future and would not be allowed to carry over the interest portion of the accumulated losses to be adjusted against profits for tax computation. All those companies which would suffer due to the proposed change should be given marginal reliefs at the time of the proposal's implementation.

Is the proposed change worthwhile? It is useful in two ways. First, a large number of profitable, levered and nonlevered, companies would immediately benefit as their tax liability would be reduced under the proposed system. What is more important

however is that the proposed change would be in the long-term interest of all companies. By proposing a substantial reduction in the corporate tax rate (bringing it down from 60% to 36%), it potentially provides enough motivation for companies to improve their profitabilities by eliminating wasteful expenses and controlling costs. The change may thus help to increase the corporate sector's profitability level in the long-run, and consequently, provide impetus to the capital market via improved share yields. Second, it would encourage a large number of moderately and marginally profitable companies to reduce their existing levels of debt to take full advantage of the proposed change. Thus the pressure for funds on financial institutions and banks may decline. Debt now would be a costly source of finance. As a result, unless a company is highly profitable, it would gain more and more (in terms of tax saved) under the suggested system by reducing its levels of debt. The proposed system may however tempt very highly profitable companies to employ more debt. The number of such companies is not large.

A CASE FOR DISALLOWING INTEREST DEDUCTIBILITY AND
REDUCING CORPORATE TAX RATE

It is commonly argued that companies in India employ high levels of debt,¹ and that the major part of the corporate borrowings comes from banks and financial institutions.² Such a pattern is suspected to result into relatively inactive stock market, lop-sided capital structures, concentration of corporate wealth and control and financial institutions finding it extremely difficult to adequately assist those sectors which are underdeveloped and to act as development banks in the true sense. The most compelling motivation for companies in India to use high degrees of financial leverage seems to be the tax deductibility of interest charges.³ It is therefore suggested that in order to reduce levels of borrowings in general and too

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- 1 See, Pandey I.M., The Pattern of Financial Leverage : A Cross-Section Study of Listed Indian Companies. Working paper No.472. Indian Institute of Management, Ahmedabad 1983; and Patil, R.E., "Tax Treatment of Interest Cost", Economic and Political Weekly, September 22, 1979.
 2. Patil, op.cit.
 3. Pandey, I.M., "Financing Decision-making : A Survey of Management Understanding". Unpublished Paper.

much dependence of companies on banks and financial institutions in particular, the interest cost, like dividends, be disallowed for tax computation.^{4,5} Viewed logically, since a company is regarded as a separate entity from its owners and lenders and since total funds employed by it are considered a pool of capital, it does not make a sense to distinguish between earnings of owners and lenders for tax purposes. The suggestion however needs a detailed examination for its implications for company financing and tax revenues to the government.

INTEREST DEDUCTIBILITY AND CORPORATE TAX RATE

The present system treats interest as a deductible expense. With the existing high corporate tax rate, a suggestion of disallowing interest deductibility would cause great hardships to companies; their tax burden would significantly increase. Thus if the aggregate tax impact of the proposal of disallowing interest is desired to be nil, then it should be ensured that the corporate tax burden does not increase and also, that the government does not suffer a loss of revenue. It is thus required that if interest

4. Patil, op.cit. For disagreement on the suggestion, see, Chitale, M.P., "Finance for Industry," Chartered Accountant. Vol. XXIX No.7 January 1981.

5. Once interest is disallowed as deductible expense, in a well-functioning capital market the choice of financing, debt vs. equity, or one type of debt vs. other type, would become irrelevant.

is disallowed, the corporate tax rate should be simultaneously brought down sufficiently. What should be the reduced corporate tax rate? This would depend on the existing corporate ratio of interest (INT) to profit before interest and taxes (PBIT), and the corporate tax rate.

Let us assume that T_1 is the current corporate tax rate and α is the ratio of interest to PBIT (INT/PBIT). Under the present system, companies have to pay taxes on profit before taxes (PBT = PBIT - INT). Thus,

$$\begin{aligned} \text{Taxes} &= \text{PBT} \times T_1 \\ &= (\text{PBIT} - \text{INT}) T_1 \end{aligned} \quad (1)$$

The proposed system would not allow deductibility of interest. Consequently, taxable base⁶ would be PBIT. Since the objective is to keep the aggregate tax burden unchanged, the new tax rate (say, T_2) should be determined in such a way that the amount of taxes remains same. Thus Eq. (1) may be written as follows:

$$\begin{aligned} \text{Taxes} &= \text{PBIT} \times T_2 = (\text{PBIT} - \text{INT}) T_1 \\ T_2 &= \left(1 - \frac{\text{INT}}{\text{PBIT}}\right) T_1 \\ T_2 &= (1 - \alpha) T_1 \end{aligned} \quad (2)$$

It may be observed that for the corporate sector α is positive but less than one ($0 < \alpha < 1$); thus $T_2 < T_1$. Let us use the data given in Table 1 (latest available) for 1720 selected medium and large

6. Except the treatment of interest, it is assumed that taxable earnings under both systems are arrived at exactly in the same way, viz., revenues minus all allowable expenses, allowances and rebates.

public limited companies, compiled by the Reserve Bank of India for illustrating the proposed system.

Table 1: Financial Data for 1720 Selected Medium and Large Public Limited Companies

(Rs. in lakhs)

	1975-76	1976-77	1977-78
1. Gross profit	1192,50	1315,18	1435,84
2. Less: interest	482,81	539,50	590,84
3. Operating profits	709,68	775,68	845,00
4. Nonoperating surplus	67,82	38,03	51,30
5. Profit before tax (PBT)	777,51	813,17	896,30
6. Less : tax provision	454,86	492,31	514,94
7. Profit after tax (PAT)	322,64	321,40	381,36
8. Profit before interest and tax (PBIT) (2) + (5)	1260,32	1352,67	1487,14
9. Borrowings	3945,04	4247,64	4610,90
10. Net worth	3916,85	4082,52	4342,92
11. Total funds (9)+ (10)	7861,89	8330,16	8953,82

Source: RBI Bulletin, May 1980.

The following relationships (Table 2) are calculated from data given in Table 1.

Table 2 : Selected Corporate Ratios

	1975-76	1976-77	1977-78
1. Interest % of PBIT	38.3	39.9	39.7
2. Tax % of PBT	58.5	60.5	57.5
3. Tax % of PBIT	36.1	36.6	34.5
4. Interest % of borrowings	12.2	12.7	12.8
5. Debt/equity ratio	1:1	1:1	1.1:1
6. Debt ratio (%)	50.2	51.0	51.5
7. PBIT % of total funds	16.0	15.2	16.6
8. FAT % of net worth	8.2	7.9	8.8

It is indicative from the above calculations that currently the corporate ratio of interest to PBIT would be 40% ($\alpha = .4$), interest rate 13% ($i = .13$), tax rate 60% ($T_1 = .6$), debt ratio (all borrowings to total funds) 50% ($\Theta = .5$) and rate of return on total funds 16.5% ($r = \text{PBIT to total funds} = .165$). Since $\alpha = .4$ and $T_1 = .6$, the proposed corporate tax rate should be⁷:

$$\begin{aligned} T_2 &= T_1 (1 - \alpha) \\ &= .6(1 - .4) \\ &= .36 \text{ or } 36\%. \end{aligned}$$

It can be seen from Table 2 also that the corporate tax as a percentage of PBIT is about 36%. Thus if interest is disallowed as a deductible expense and the corporate tax rate is reduced to 36%,

⁷Values assigned to α and T_1 could be slightly different in the judgement of others. Accordingly, T_2 could be different. However, the conclusions of the paper would not be affected by such differences.

the aggregate tax burden of companies would not be affected and nor would the exchequer lose. However, individual companies would be affected differently - for some the effect would be favourable while unfavourable for others. The implications of the proposed change are discussed in the following section.

PRESENT VS PROPOSED SYSTEMS

The proposed system, as contrasted to the existing system, would affect the tax liabilities of individual companies depending on their existing profitabilities, levels of debt and share of interest in total earnings (PBIT). The increase or decrease in the tax burden would constitute a net loss or gain to shareholders. Thus the impact of the proposed system can be analysed in terms of the differential effect on the shareholders' return (or distributable surplus).

The following equation can be used to determine the return on equity under the present system.⁸

$$ROE_1 = \left[r + (r-i) B/E \right] (1-T_1) \quad \dots(3)$$

⁸ If B = borrowed funds, E = shareholders' funds, C = B + E, r = rate of return (PBIT ÷ C), i = interest rate, and T₁ = Tax rate, then

$$\begin{aligned} ROE_1 &= \frac{rc-iB}{E} (1-T_1) \\ &= \frac{r(E+B) - iB}{E} (1-T_1) \\ &= \left[r \left(1 + \frac{B}{E}\right) - i \frac{B}{E} \right] (1-T_1) \\ &= \left[r + (r-i) B/E \right] (1-T_1) \end{aligned}$$

If $B/C = \Theta$, then $E/C = 1 - \Theta$ and $B/E = \Theta / (1 - \Theta)$. Thus Equation (3) can also be written as:

$$ROE_1 = \left[r + (r-i) \frac{\Theta}{1-\Theta} \right] (1-T_1) \quad \dots\dots(4)$$

Using the corporate sector's 'average' values for various variables in Eq. (4), the 'existing return on equity (ROE_1)' is:

$$\begin{aligned} ROE_1 &= \left[.165 + (.165 - .13) \frac{.5}{1-.5} \right] (1-.6) \\ &= .08 \text{ or } 8\% \end{aligned}$$

The 8% is the corporate sector's book return on equity and corresponds with the figures in Table 2 (obviously!).

Under the proposed system interest would be nondeductible. Thus the following equation will be used to calculate return on equity:

$$\begin{aligned} ROE_2 &= r(1-T_2) + [r(1-T_2) - i] B/E \\ \text{or } ROE_2 &= r(1-T_2) + [r(1-T_2) - i] \frac{\Theta}{1-\Theta} \quad \dots\dots(5) \end{aligned}$$

Substituting values in Eq. (5) we again get:

$$\begin{aligned} ROE_2 &= .165(1-.36) + \left[.165(1-.36) - .13 \right] \frac{.5}{1-.5} \\ &= .08 \text{ or } 8\% \end{aligned}$$

It is obvious that T_2 (the proposed tax rate of 36%) has been determined in such a way that the aggregate impact of the proposal is nil. However, values of variables in Eqs (4) and (5) for individual companies would be different from the 'average'. As a result, they stand to gain or lose, or could also remain unaffected due to cancelling effects of variables.

It is clear from Eq. () that under the present system, for any company for which r and i are constant (or changing) and $r > i$, ROE_1 would increase with $\theta / 1 - \theta$ (or B/E , debt-equity ratio). On the other hand, debt will not be beneficial from the shareholders' point of view (that is, ROE_2 would not increase) under the proposed system (Eq.5) unless $r > i / 1 - T_2$. Thus $i / 1 - T_2$ being greater than i , a company will have to earn a higher before-tax return under the proposed system to take advantage of leverage. Thus, if interest rate is 13% and the corporate tax rate is 36%, it will not pay to the shareholders of a company to employ debt under the proposed system unless it earns more than 20.3% (that is, $.13 \div (1 - .36) = .203$) return on its funds. The higher the interest rate, the higher will be the required return on total funds to reap the benefits of leverage.⁹ In contrast, with the present system of tax deductibility of interest, the company that pays interest at 13% needs to earn a rate of return greater than 13% to take advantage of debt. Moreover, under the present system, with a 60% tax rate, the effective cost of debt for companies in India works out around 5-6%. The present system thus motivates even a marginally profitable company (an after-tax return of 5-6% is marginal) to employ debt. The use of debt by marginally profitable companies is a dangerous financial policy since leverage increases earnings per share but also chances of insolvency and financial distress.

9. If a company, for example, can borrow only from banks at a rate of, say, 18% it will have no leverage advantage unless its return (r) is greater than 28% [$.18 \div (1 - .36) = .28$].

The net effect of the proposed system for an individual company is the difference between the tax saved due to reduced tax rate and tax lost due to nondeductibility of interest. Subtracting Eq.(4) from Eq.(5), this difference can be expressed as follows:

$$\begin{aligned} ROE &= r(T_1 - T_2) + \left[r(T_1 - T_2) - T_1 i \right] \frac{\theta}{1-\theta} \\ &= r\Delta T + (r\Delta T - T_1 i) \frac{\theta}{1-\theta} \end{aligned} \quad (6)$$

Since we have assumed $T_1 = .60$ and $T_2 = .36$, Eq. (6) can be rewritten as follows:¹⁰

$$ROE = .24 r + (.24r - .6 i) \frac{\theta}{1-\theta} \quad (7)$$

Using the 'average' values to Eq. (7), we get;

$$ROE = .24 \times .165 + (.165 - .6 \times .13) \frac{.50}{1-.5} = 0.$$

It is worth repeating to say that the proposed tax rate is suggested on the basis of the current 'average' ratios of interest to PBIT, debt to total funds etc. As a consequence, individual companies different from the 'average' would be affected by the proposed change.

It should be obvious from Eq. (7) that nonlevered companies (i.e., those which do not employ debt) would save tax equal to 24% of PBIT. The shareholders' rate of return would consequently increase by $.24 r$ ¹¹. The higher the profits of the nonlevered company, the higher would be the amount of tax saved, and thus distributable surplus. It is noteworthy that under the existing tax policy, the government pays 60 paise (60%) while the company

10. Eq.(7) can also be presented in the following ways:

$$ROE = \frac{1}{1-\theta} \left[.24r - .6 i \theta \right] \quad (7A)$$

11. For the profitable nonlevered companies, the expression

$$(.24r - .6 i) \frac{\theta}{1-\theta} = 0, \text{ since } \theta = 0.$$

pays 40 paise (40%) in every rupee of its (company's) expense. Now the company will have to pay 6½ paise (64%) and the government 36 paise (36%). As a result every rupee of expense saved will bring additional profit of 24 paise. Generally speaking, a substantially low corporate tax rate under the proposed system should motivate a large number of companies to improve their profits by controlling expenses, particularly discretionary expenses.

The profitable levered companies may gain more or less than the nonlevered companies or may lose due to the proposed change. Those levered company, for which the expression $(.24r - .6i)$ is positive (that is the tax saved due to reduced corporate tax rate is greater than the tax lost due to nondeductibility of interest), would gain more than the nonlevered companies by the proposed change. The expression $(.24r - .6i)$ would be positive when $.24r > .6i$ or $r > 2.5i$.¹² Thus, a levered company paying interest at, say, 13% would have to earn a rate of return of more than 32.5% (i.e. $.24r > .6 \times .13$ or $r > .325$). Similarly, r should be greater than 22.5% if $i = 9\%$; or $r > 45\%$ if $i = 18\%$. It can be thus stated that those levered companies which have rates of return of less than two and half times of their interest rates could be motivated to reduce the levels of debt if they want to take full advantage of the proposed system. On the other hand, levered companies satisfying the condition of $r > 2.5i$ could be tempted to employ more and more debt than their present levels since that would help

¹² Stated differently, r would be greater than $2.5i$ when interest (INT) as a ratio of profit before interest and tax (PBIT) is less than 40% (or $i/r = .4$).

them to save more and more tax under the proposed change¹³. Given the present interest rates on various types of debt, it can be safely concluded that a large number of companies' rates of interest would be close to 13%. Thus in most of the cases r will have to be quite high (say, greater than 32.5%, or around 25% in some other cases)¹⁴ for the existing companies to be motivated in the direction of employing more debt due to the proposed change. There may not be much objection to highly profitable companies employing high level of debt.¹⁵ The number of highly profitable companies in India would be quite small, however.¹⁶

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13. Other things remaining same, such companies would have maximum ROE when debt ratio is almost 1 (say, $\phi = .99$). Financial risk will also reduce for those companies under the proposed system vis-a-vis the existing system.
 14. The number of companies paying interest at below 9-10% is unlikely to be large.
 15. The optimum (rather appropriate) level of debt for a company would depend on the risk-return trade-off. Debt increases shareholders' earnings but also risk of insolvency.
 16. A recent study based on the data of 743 companies selected from the Bombay Stock Exchange Directory showed that in the year 1980-81, only 6% of companies had return on capital higher than 30%, and 19% of companies higher than 20%. About a half of companies' returns varied between 5-15%. It was also revealed that there was no significant relationship between the company profitability and degree of leverage employed. See, Pandey I M, "Pattern of Financial Leverage", op.cit., Exhibit 26.

How would less profitable companies be affected? Eq.(7) clearly reveals that for those levered companies which have $r < 2.5 i$, the expression $(.24r - .6i)\frac{\theta}{1-\theta}$ would be negative. These levered companies would however benefit from the proposed change, but less than the unlevered companies, for which the overall contribution of the reduced tax rate is more than the loss of interest tax shield. Generally, all these companies would benefit which satisfy the following condition:

$$\begin{aligned}
 &.24 r + (.24 r - .6 i) \frac{\theta}{1-\theta} > 0 \\
 \text{or } &.24 r \left(\frac{1}{1-\theta} \right) > .6 i \frac{\theta}{1-\theta} \\
 \text{or } &r > \frac{.60}{.24} i \theta \\
 \text{or } &r > 2.5 i \theta \qquad \dots (8)
 \end{aligned}$$

For example, if we assume $i = 13\%$ and $\theta = 50\%$ for a company, it will benefit by the proposed change if its $r = 16.5\%$ (i.e., $r > 2.5 \times .13 \times .5$ or $r > .165$). Suppose the company's $r = 16.5\%$; it would neither gain nor lose by the proposed change. However, it would gain under the proposed change if it reduces its debt - the maximum gain (of $.24 r$) occurring when the company does not have any debt. Further, assume that the company's r is greater than 16.5% ($r > 2.5 i \theta$); for example, it is 19.5% . Since now $r = 19.5\%$ is greater than $2.5 i \theta = 16.5\%$, it can increase its debt level upto 60% ¹⁶ and still gain by the proposed change. But the motivation for the company should be to reduce rather than increase, the level of debt since it can save tax on account of the

16. $r > 2.5 i$
 $.195 > 2.5 \times .13 \theta$
 $.195 > .325 \theta$
 $.195 = .325 \times .6$

θ , by definition, should be less than 1. Thus, for $r > 32.5\%$, a company would maximize tax benefit by employing maximum debt (say, $\theta = .99$).

proposed change. It is thus clear that all those levered companies which fall under the boundary $2.5 i \leq r < 2.5 i$ will benefit by the proposed change. Companies with returns falling within the range of $2.5 i$ and $2.5 i$ for given levels of debt would be encouraged to reduce debt since the proposed system provides them an opportunity to reduce tax and thus increase distributable profits by doing so. As stated earlier, companies with $r > 2.5 i$ would reap maximum benefit of the change by increasing debt as much as possible; the number of such companies is not large, however.

The proposed system would penalise levered companies with $r < 2.5 i$. Thus less profitable and less or highly levered companies would have to pay more taxes (as compared to the present system), which would reduce their distributable profits (in other words, the differential ROE would be negative, $ROE < 0$). The combination of low profitability and high level of costly debt would cause the maximum penalty under the proposed system. The change therefore should force managements of such companies to improve their profitabilities,¹⁷ and with sufficient generation of funds even to liquidate existing levels of debt.

The proposed system could change marginally profitable levered company into loss-making company. Those companies which are presently earning just sufficient to pay interest cost or less (i.e., $r \leq i$) would show losses since they will have to pay taxes once the proposal of disallowing interest deductibility is implemented. The change would also have adverse effect for loss making or sick companies and new companies in the long-run. There would not be any immediate

¹⁷. A reduction of 24% in the corporate tax rate should be tempting enough for companies to tighten up the cost incurrence.

effect as these types of companies presently would not be paying any taxes. They would suffer in subsequent years when they would become profitable and would not be allowed to carry the interest part of the accumulated losses for adjusting against profits for computing taxes (but they would save as much as 24% tax on the remaining profits). Sick and new companies are specially treated presently and are given a number of concessions and incentives. While implementing the proposed change, they can be given some relief for a few years. The marginally profitable companies which would show losses because of the proposed change could also be given some concession at the time of the proposal's implementation. As a long-run policy, however, inefficient companies need not be supported by financial institutions or others indefinitely. The proposed change, because of the reduced corporate tax rate, is generally in the benefit of the corporate sector, the profitable and prudently financed companies benefiting the most. The existing inefficiently management companies would therefore be motivated by the proposed change to become more profitable and make use of debt cautiously.

CONCLUDING OBSERVATION

It is suggested in this paper that interest may be disallowed as a deductible expense to reduce the corporate sector's excessive dependence on borrowings, particularly borrowings from financial institutions and banks. The corporate tax rate is also suggested to be reduced simultaneously so that the aggregate tax burden of companies remain unaltered and the government does not suffer any loss of tax revenue. The existing corporate tax rate is about 60% and interest to profit before interest and taxes ratio 40%. Thus the proposed tax rate can be fixed at 36% while disallowing the tax deductibility of interest.

The proposed system would however cause reallocation of tax burden among individual companies - some benefiting by tax savings while others losing by paying more taxes. One consequence of the proposed change is that debt would become a costly source of finance, and consequently, now a company will have to be more profitable than under the existing system to take advantage of leverage for increasing the shareholders' return. The proposed change would result in incremental benefits to all profitable nonlevered companies; they would save taxes equal to 24% of their earnings (PBIT). These companies would be encouraged to take greater advantage of the proposed change by increasing their profitabilities through improved operations and cost controls. The highly profitable levered companies ($r > 2.5 i$) would benefit more than the profitable nonlevered companies. To

maximise benefits of the proposed change, they may employ more debt than their present levels. The number of such companies is not very large. The moderately profitable levered companies would also benefit, but less than the profitable nonlevered companies, provided they do not earn less than two and half times of interest rate into debt ratio ($r > 2.5 i \theta$). The proposed system is expected to influence managements of such companies either to increase their profitabilities and/or reduce levels of debt to take full advantage of the change. Thus the magnitude and quality of such companies' distributable profits is likely to improve in future. The increased distributable surpluses, occurring immediately and/or in future to a large number of companies on account of the proposed change, when properly utilised, either distributed as dividends to shareholders and/or reinvested in profitable operations, should help to improve yields on shares, and thus, may bolster up the flow of capital from the stock market. A shift, although gradually, in favour of the stock market by companies for raising funds would help relieving pressures on financial institutions and banks, and bringing capital structures into balance.

The less profitable levered companies ($r \leq i \theta$) would be adversely affected by the proposed change. The marginally profitable but highly levered companies would suffer the maximum ^{loss} if the suggestion for disallowing interest for tax computation is implemented. Such

companies would lose more by way of loss of interest tax shield than the gain arising from the reduced tax rate. At the time of the proposal implementation these companies should be given marginal reliefs and concessions to mitigate or eliminate the immediate adverse effect of the change. The proposed system, by providing a substantial reduction in the corporate tax rate, would motivate the less profitable companies to improve their profitabilities and/or reduce levels of debt in the long-run.

There would not be any immediate effect of the change on sick and loss-making, existing and new companies. They would be affected however in later years when they would become profitable and would not be allowed to adjust interest portion of accumulated losses against profits for computing taxes. Such companies should also be provided with reliefs and concessions while introducing the proposed system.

The detailed examination of the suggestion of disallowing tax deductibility of interest cost and reducing the corporate tax rate shows that a large number of profitable companies would immediately benefit as they would be enabled to save taxes. What need to be emphasised however is that the proposed change would be in the long-term interest of all companies. The proposed change, by suggesting a substantial reduction in the corporate tax rate, would motivate companies to improve their profitabilities by eliminating wasteful operations and controlling costs. A large number of companies would also be encouraged to reduce their levels of debt to take full advantage of the proposed change. It is thus hoped that corporate

sector's dependence on financial institutions and banks would reduce and perhaps the stock market would also get activated.

One unfavourable effect of the proposed change could be that due to nondeductibility of interest, companies may be discouraged to raise debt (in the form of debentures/bonds) from the capital market. This problem can be overcome by allowing, fully or partially, deduction of interest on debt raised from market. In that case, the proposed corporate tax rate would have to be fixed at a rate higher than 36%.