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Establishing good governance and transparency in corporate business

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The national budget for the fiscal year 2014-15 has a number of distinct features that will bear significant implications for the future of capital markets in the country.

The budget involves a planned developmental spending of 6.4 per cent of our gross domestic product (GDP). The plan envisages a 2 percentage-points-surge over the past three-year average of actual developmental spending of the government. It is associated with an obvious 5.0 per cent fiscal deficit; two-thirds of which are planned to be met by domestic borrowings. The planned government borrowings would likely crowd out loanable funds for private sector investment. And it would happen at a time when the entire financial system is facing mounting bad loans for a variety of reasons. The crowding out effect implies that borrowing costs would rise again and corporate businesses would not pursue marginal investment opportunities. Thus productive capacity of the manufacturing and service sectors is likely to remain stagnant as it has been over last few years.

A rising borrowings cost will erode earnings before taxes (EBT) and redistribute free cash flows (FCFs) from stockholders to bondholders. The forgone new investments on the other hand would constrain growth in expected earnings before interest and taxes (EBIT). Public dissaving, largely to be financed by domestic borrowings, will, therefore, have double-edged adverse effects for expected stock prices. It will lower both expected earnings per share (EPS) and growth in EPS.

It should be noted that the planned spending rise is largely due to the government's political commitment to embark upon a few large infrastructure projects. Notable among them is the planned funding of Padma Bridge construction. It is true that an effective construction of Padma Bridge will have far-reaching effect on the long-run economic growth of the country. But in the short to medium term, it is likely that the saving-investment gap and so the external account balance would worsen. An accommodative strategy to avert such adverse effects can be a potential depreciation of the home currency and thereby to facilitate both exports and remittances. This is, however, outside the purview of fiscal policy. But that option is also constrained in the sense that Bangladesh Bank would likely face an overarching goal of price

stability. An enhanced coordination between the central bank and the Ministry of Finance (MOF) is ever more important.

Another feature of the budget 2014-15 is about tax policies-both corporate and personal tax policies in the country. Entrepreneurs and investors have long demanded a favourable tax regime for corporate businesses and also for rationalising personal and capital gain tax rates so that investing in equities becomes lucrative. The new tax policy seems to have missed this goal.

CORPORATE TAX REGIME: Let us first examine the corporate tax regime. At present, statutory corporate tax rates vary from 27.5 per cent to 45 per cent. Specifically, statutory tax rate for banks and financial institutions is 42.5 per cent. It is in the range of 40 to 45 per cent for mobile and tobacco companies. The other publicly traded companies (including manufacturing and non-financial service companies) are subject to 27.5 per cent provided that they declare and pay a minimum ten per cent dividend. Other companies which are not publicly traded are subject to a statutory tax rate of 35 per cent. The current finance bill thus lowers corporate tax rate by 2.5 per cent only for the unlisted companies.

It is well-know that the unlisted companies face little regulation and are largely non-transparent. A relative tax advantage though exists for the publicly traded companies in the non-financial sector, the publicly traded banks and NBFIs are subject to a prohibitively high 42.5 per cent, which is 7.5 per cent higher than that of the unlisted companies. Everyone knows that listed banks and financial institutions are subject to stricter regulations of the central bank, Bangladesh Securities and Exchange Commission (BSEC) and stock exchanges. A policy to tax them at 42.5 per cent is inconsistent for promoting corporate good governance. Relative advantage for listing in stock exchanges is also diminished. It is an empirical regularity that listing requires enhanced compliance with corporate laws and accounting regulations and thus involves a set of incremental costs including information production costs and political costs. The current fiscal policy is, therefore, not creating incentives for good governance and transparency in corporate business.

PRAGMATIC CORPORATE TAX POLICY: A chronic incapacity and inefficiency of tax administration has long constrained government finance. D. Chen and J. M. Mintz of Cato Institute in a recent study found that effective corporate tax rate in Bangladesh was only 14.5 per cent in 2010. The study further showed that the rate was 33.6 per cent for India and 34.6 per cent for the United States. A large gap between the statutory tax rate and a very low effective corporate tax is a clear manifestation of pervasive tax avoidance and an inefficient tax administration in Bangladesh. A pragmatic corporate tax policy must involve a substantial cut and it would yield a number of benefits in the long-run.

First, a reduction in corporate tax rates will help corporate businesses generate more operating cash flows and so conserve more cash for their businesses. A scope to conserve more cash essentially implies that the after-tax cash flows to investors will rise in the long-run. It happens via two channels. One is that an enhanced operating cash flow will enable corporate management to pursue positive NPV projects and thus to enhance future profitability. It would yield capital gains to shareholders. The other is that companies will have more free cash flows (FCF) which is operating cash flows net of cash used for investments. A growing free cash flow will in turn lead

to an increasing dividend payout to the shareholders. Personal taxation regime here becomes relevant. In modern taxation cash dividends are double-taxed-first at the level of corporation and then at level of investors. This is contrasted with capital gains that arise from retention and reinvestment of profits. The capital gains are also double-taxed but at a much lower capital gain tax rate. Following Modigliani-Miller Theory of Investment, value relevance of a reduction in corporate tax rate can be shown to be substantial.

The second implication of a reduction in corporate taxes lies with respect to the choice of debt financing. The existing corporate tax system, which provides for tax deductibility of interest expense, encourages excessive financial leverages. Corporate management motivated by tax advantage of leverage tends to over-borrow and faces rising bankruptcy costs. This is particularly the case when business environment experiences rising borrowing costs amid contractionary monetary policies. In fact, when Bangladesh Bank pursued a relatively contractionary monetary policy at the end of 2010, it was the cohort of highly levered firms, including banks and NBFIs notably, that experienced drastic fall in profitability and so the decline in their stock prices. The observation is also true for local non-financial companies that are found to be relatively more levered. A long phase of depressed pricing in our stock market is an outcome of corporate management's choice of excessive debt financing. Had there been a lower corporate tax rate, no opportunity of low-cost borrowing and an effective regulatory environment during the pre-crisis time, the unfortunate bubble and its subsequent bust in the stock market could be averted.

Third, the proposed tax regime would likely face a criticism that it would lower government tax revenue. The argument is untenable on the ground that an increased dividend income to the shareholders and a positive wealth effect of potential capital gains would have positive impact on aggregated demand. To the extent, corporate income tax collection declines, an offsetting improvement will occur in the form of other taxes due to rising aggregate demand. To support the short-fall in the short-term, tax base should be broadened in order to enhance tax neutrality. Tax administration must be reformed so that tax avoidance by companies declines over time. In the long-run, government tax revenue is unlikely to be adversely affected. Chen and Mintz argued that in a global economy a lower corporate tax rate would rather avoid "income shifting" by multinational companies from high-tax to low-tax jurisdictions.

Fourth, existing tax system underlies a classic corporate governance problem in that controlling shareholders and management depend more on borrowings and less on equity financing. An outcome is that shareholding concentration deepens and external shareholders become more marginalized. A lower corporate tax rate would encourage equity financing instead of debt financing and it would dilute stockholding from the controlling shareholders to the external shareholders. Corporate board will be more accountable. Frequency of transactions between firm and insiders to expropriate depositors and external shareholders will likely decrease.

Finally, a significant reduction in corporate tax rate would reduce hurdle interest rate for investment and lead to increased capital expenditure. Capital allocation process will become more efficient. With the abolishing of too many special tax brackets for segments of businesses, tax planning and administration would be a lot simpler. The policy change will likely stimulate private sector investment. Given that investment demand in the country remained stagnant for the last few years and that the financial sector has excess liquidity, a pragmatic tax policy could

have a real potential to revitalise corporate business and so the moribund stock market in Bangladesh.

This proposal does not however negate the long demand of improving tax administration of the country and reforming the public spending system. It is also noteworthy that the Bangladesh Securities and Exchange Commission (BSEC) is seriously constrained in terms of skilled man power. The organisation also lack in modern infrastructures to ensure effective monitoring of the stock exchanges. It can hardly verify information production system of corporate management and does not yet have a proper regulation as to corporate audit. Non-compliance with disclosure requirements is pervasive and often goes unchecked. The regulator does not have technical capability to validate offer prices of initial public offerings (IPOs) and other issues of securities. Many of its policies are ad-hoc and, sometimes, against good governance of capital market. The practice of certified public accountants (CPAs) is de facto unregulated and audit opinion is rarely perceived reliable. Stock exchanges continue to face an organised broker control in the conduct of businesses. Political considerations dominate in the selection of top regulators in the country. Selection of top executives in the state-controlled enterprises is hardly meritocratic. These are the structural weaknesses and require to be addressed systematically for a developed capital market in the country.