

# How will a new tax regime affect the stock market?

MIZANUR RAHMAN

THE finance minister will present a new budget in a few weeks. A major public policy concern is to define a tax policy regime which will promote private sector investment and revitalise a moribund (de facto) stock market. We propose that tax rates decrease across the board.

Firstly, a reduction in corporate tax rates will help corporate businesses generate more operating cash flows and so conserve more cash for their businesses, which 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 enhance future profitability. It would imply capital gains to shareholders. The other is that companies will have more free cash flows which will lead to an increasing dividend payout to the shareholders. Personal taxation regime here becomes relevant. Modern taxation is that cash dividends are subject to personal tax rate whereas capital gains from reinvestment of profits would be subject to a lower capital gain tax rate. Following Modigliani-Miller Theory of Investment, value relevance of tax policies is apparent and outlined below.

Assume a hypothetical environment where corporate tax rate is 50%, personal tax rate is 25%, and an all equity firms with earnings before interest and taxes (EBIT) of \$1.0. If the required rate of return by the shareholders is 10% and the firm adopts a 100% payout of profit after taxes, the value of the firm would be \$3.75. Now if the firm uses debt in its capital structure with no change in its business operations and so no change in the expected EBIT, the value of the firm would rise by \$0.375 for each dollar of debt in the capital structure. It is assumed that both stockholders and bondholders require the same rate of return.

Now assume that tax planner reduces corporate tax rate from 50% to 30% with everything else remaining unchanged. With a 100% payout policy, an all equity firm would now be valued at \$5.25 instead of

\$3.75, which is equivalent to a 40% rise. In the case the firm is levered, i.e., uses debt in its capital structure, each dollar of debt would mean an additional \$0.225 for the value of the firm.

A question arises that a firm hardly follows a 100% payout policy in the long-run and so the above illustration is an extreme point. Let us consider a more plausible case that the firm follows a 50% payout of its earnings after taxes and retains and reinvests the rest in the business. Given that personal income tax rate is 25% and capital gain tax rate is 10% and that corporate tax rate is 30%, an all equity firm would now be valued at \$5.78. A reinvestment of profits even in zero-NPV projects further enhances the value of the firm and it arises from tax savings due to a lower capital gain tax rate. So a payout of 50% instead of 100% increases value of the firm by a further 10%. Should the firm use debt in its capital structure, additional tax advantage of debt will be \$0.17 for each dollar of debt. A new tax policy with a reduced corporate tax rate will thus enhance value of the firm and the potential impact is unambiguous.

The second implication lies with respect to financing decisions by firms. The present corporate tax system, which provides for deduction of interest, encourages excess leverages. Corporate management motivated by tax advantage of leverage tends to over-borrow and risks falling profitability and increased bankruptcy costs. This is particularly the case when business environment experiences rising interest rate 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. 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 burst in

the stock market would have been averted.

Third, the proposed tax regime would likely face 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. In the long-run, government tax revenue is unlikely to be adversely affected.

Fourth, the existing tax system underlies a classic corporate governance problem. It is 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 marginalised. 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 and probability of insider trading will decrease. Capital allocation and investment decisions will become more efficient. 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. 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 does 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 another issue and not to be addressed in this note.

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# The new Right: Europe and Asia's neoliberal shift

AHMAD IBRAHIM

NARENDRA Modi's ascension to power has brought with it volumes of articles and opinions published about the fate of India under the BJP's leadership (a party with clear links to RSS, which many view as its puppet-master). While the hardliner, nationalist image of Narendra Modi might just have to be daubed in a dash of diplomacy, there is no denying the shift from the left of centre UPA-led government under Congress to the right of centre government in place today. Qualms have been raised about the nationalist fervour which Modi brings with him and whether India's secular nature, long perceived by many as ailing, about to erode away completely. But, in line with the rampant spread of free-market ideologies throughout the world, economic goals are increasingly becoming the number one priority of good governance.

What Modi brings with him is the Gujarat-model of development, meant to provide a red carpet for corporations to take roots throughout India. A move that will no doubt coincide with not only widespread infrastructure growth and development, but also a bulking up of the wealth of the 1%. Congress's failure in this case was a stuttering economy and weak governance.

Globally, though, Modi's victory should hardly come as a surprise. We need only to look as far as South Korea and Japan to see a trend emerging. Geun-Hye Park, the current South Korean president, leads a strong right wing party which focuses on mobilising civic organisations. Japan's Shinzo Abe is another example of the right-wing shift in the continent. Abe, Park and Modi all get substantial backing from large globalised corporations. Their mantra mixes economic liberalism with a nationalist fervour which is supported strongly by the middle-classes dreaming of economic emancipation along with a vision of propelling their respective cultures to the forefront in the age of globalisation. The civic organisations that have been mobilised include the New Right movement and the Liberty Union in South Korea and the Rashtriya Swayamsevak Sangh in India. These organisations run on neoconservative ideals which often have close ties to the dominant religion and culture of the respective countries.

The recently concluded EU polls also indicate that Europe is set to undergo a right-wing catharsis sooner or later. France's far-right National Front Party was the outright winner in France, seen by many as the political epicentre of Europe. A France that has long lived on its republican ideals liberté, égalité and fraternité is now entrenched with the rightist claim that its Muslim population is incompatible with the French republic. Fuelled by the Eurozone crisis and widespread immigration throughout the EU, the European nations have propelled ultra-nationalist and often anti-Islamic and anti-Semitic political parties from the fringes to the mainstream. In France, Marine Le Pen has taken the National Front to the summit, as shown by recent surveys. In the UK, Nigel Farage, leader of the fiercely anti-EU UKIP party, looks set to gain a historic win over both the Conservatives and the Labour parties. The anti-immigration and anti-EU Danish People's Party snatched victory in Denmark and, although they did not win, Greece's Golden Dawn, a party with past ties to neo-Nazi sentiments, came in third with about 10% of the votes.

Although established pro-EU parties have been backed to retain majority of the Parliament, the sudden shift towards the right points to the growing disillusionment in Europe with the economic cost of a single currency and the free movement of cultures within the EU. It would be naïve to draw parallels between the economic or political situations of the countries in Asia and those in Europe but in both cases a new right is on the rise. One that amalgamates neoliberal ideals of development with that of nationalist pride.

To understand the link between neoliberalism and nationalism we must delve into the psyche of capitalist states. Capitalist competition provides a self-interested desire by each capitalist to use non-economic means to gain an edge. On a micro level the competition exists between competing firms and on a macro level the nation states. It is very much a marriage of convenience between neoliberal capitalism and nationalism which creates defined states of people that can benefit more than others. Without a nationalist state and with free movement and mixing the gains from neoliberal capitalism would be spread out over all states -- the very antithesis of competition which follows the rule of 'survival of the fittest.' The drawbacks of the neoliberal school of thought have been there for all to see for a long time now. It has created an underclass stuck with low wages and welfare payments, a middle class burgeoning with debt and insecurity, and a small percentage of the upper class who are given the economic freedom to dictate the terms of a country's governance.

But the marriage of neoliberalism with nationalism presents an even graver danger to the people of the world. It stands to not only benefit the rich and suppress the poor, but to segregate communities and derive them of opportunities based on race, religion and culture. Economic oppression due to cultural differences is not an alien concept but it might evolve into a new monster entirely with the recent developments.

The rise of the right in Europe and Asia is something that has been in the pipelines for a long time now. The insecurity over the merging of cultures due to globalisation has no doubt played its part in this, and the 'invisible hand' of the market has swooped in to take advantage. We might soon see mega-cities and sparkling infrastructure being contrasted by the destitute state of the poor and the oppressed minorities who have made the heinous mistake of choosing a different religion, or being born on the wrong side of the border.

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# New US foreign policy doctrine: Old wine in new bottle?

TAHMINA RAHMAN

JUST because we have the best hammer does not mean every problem is a nail' -- Barack Obama, Commencement speech at West Point, 2014.z

A few days ago, while addressing a fresh batch of graduates at West Point, President Obama made it clear that he sees America as the global leader that does not rely on brute force to solve every problem. He reiterated the popular American belief 'America must always lead on the world stage. If we don't, no one else will.'

This doctrinal shift in foreign policy that supports diplomacy based on soft power and financial assistance to fight international terrorism might have been aimed at reassuring those who were afraid of what seemed like an increasing isolationist tendency in the US foreign policy. It could also comfort those who opposed America's unremitting interventions around the world. Just two days before addressing the graduates at West Point, Obama made a surprise visit to Afghanistan and reassured the American soldiers serving there that the mission in Afghanistan will come to a "responsible end." Is this war fatigue talking through President Obama? Although some observers might find an uncanny similarity between temporary US retrenchment into its own cocoon right after the failures in Korean and Vietnam wars with what the president is envisaging now, American historian Robert Kagan thinks it's 'world weariness' that America is suffering from these days. President Obama's commitment to a more restrained and responsible engagement with the international community

might as well be interpreted by some as growing lethargy rather than a renewed vow to its global leadership role.

Now what could have caused this epiphany that made Obama realise the diminishing utility of military power in steering his foreign policy? A few reasons promptly come to mind -- overstretched and resource consuming operations in Iraq and Afghanistan, a struggling economy, and decreasing international legitimacy for the way America engages with the world, and so on. Pundits are arguing over whether Obama has publicly announced a deviation in American foreign policy from its over-indulgence with military power. Skeptics like Senator Graham Lindsay said: "President Obama is not ending wars, he's losing them."

Basically, the president talked about the right to use force unilaterally when American interests are stake, and go for alliances and partnerships when threats are not directly posed against America. Demarcating areas and interests this way sends a subtle and negative signal to those who have been left out and damages the credibility of the global leader.

But is such a change in American foreign policy rhetoric a real aberration from tradition or sophisticated trickery with words? The whole speech revolved around the importance of counterterrorism. Glorification of his administration's success in counterterrorism so far and his future plans on this issue occupied the major portion of the president's speech. He did not give any clear guideline on how he was planning on keeping the USA in the global leadership position. Except for that \$ 5 billion partnership fund for fighting terrorism, he did not present

any concrete proposals to translate his ideas into actions. It is very surprising how little President Obama had to say about trade and investment and the importance of Asia in America's economic recovery. He also did not utter a word on how to overcome the various legal, technical and political problems that hinder 'collective action' in international relations.

He did talk about climate change. And he expressed discontent over America's aversion toward international treaty commitments like the United Nations Conventions on the Law of the Sea. But the fleeting references to those issues hardly prove a change in foreign policy.

In a sense the speech was a response to the growing criticism of America's inaction or inadequate action in the face of problems like Russian activities in Eastern Europe and Chinese theatrical show of power in the South China Sea. This was no big departure from the 'light footprints' approach that Obama took up in his first term. BBC's North American editor Mark Mardell opines that the president has not brought forth a 'shinning new dawn of peace and democracy.' The speech sounded like a mere restatement of previous foreign policy posture, may be with a renewed vigour.

Borrowing from Richard Haas (President of Council on Foreign Relations), what America needs now is tying foreign policy with the domestic one so that "people understand that what happens here in the United States affects our ability to act in the world, and what happens in the world will in many ways affect the quality of life here." Apparently, President Obama likes to keep those realms separate and

thus risk poor policy choices.

The real question is whether this rhetoric of less aggressive foreign policy matches the reality on ground. How popular will his newly envisioned foreign policy be with the hawks that are critical of Obama's soft approach in Syria and Ukraine? Will the Congress approve the \$5 billion counterterrorism partnership fund? How welcome will be his idea to support Jordan, Lebanon, Turkey and Iraq in hosting refugees and controlling terrorists? Will the changes please people like Senator Bob Corker, who is still hesitant about the schedule for troops withdrawal from Afghanistan? For all the president's confident claims about cornering Putin with less aggressive means in association with American allies, France is still on for warship sale to Russia and the sanctions do not seem to keep Putin awake at night. Drone strikes are still a reality and Guantanamo Bay is in operation. So the president has got a lot of explaining to do before convincing the skeptics that his 'new and improved' version of foreign policy is actually something new and does pay off.

In whichever way his proposed changes are received in America and around the world, he will not be worried about "critics who think military intervention is only way for America to avoid looking weak." With only two years remaining in power, it would be interesting to see how Obama convinces the critics about the utility of this supposed 'doctrinal shift' and how well he implements those promises he made at the West Point.

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## QUOTEABLE Quote

A preoccupation with the future not only prevents us from seeing the present as it is but often prompts us to rearrange the past.

Eric Hoffer

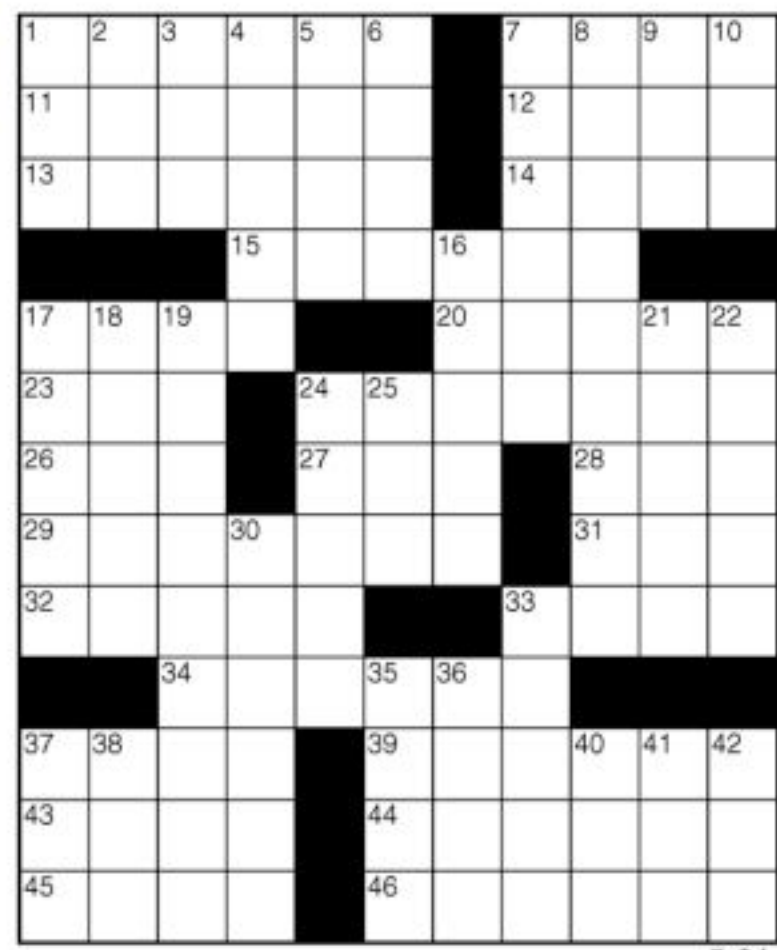
## CROSSWORD by Thomas Joseph

### ACROSS

- 1 Unanimously
- 7 A long time
- 11 Extreme dishonor
- 12 Company sign
- 13 Rob and Laura's last name
- 14 Fan's favourite
- 15 Labels with names
- 17 Put together
- 20 River of Provence
- 23 Swearing in vow
- 24 Anticipate
- 26 Old horse
- 27 Tea cooler
- 28 Triumph
- 29 Positive aspects
- 31 Wagon puller
- 32 Put away
- 33 Worry
- 34 Dipping treat
- 37 Eastern sight
- 39 Source
- 43 Jai-
- 44 Disregard
- 45 Painter Chagall
- 46 Pulled in

### Down

- 1 Pointer
- 2 Binary digit
- 3 Back at sea
- 4 Raymond's TV mom
- 5 Surrounded by
- 6 Dmitri's denial
- 7 Step down
- 8 Ares and Mars
- 9 Sense of self
- 10 Peruvian coin
- 16 Spring sign
- 17 Less
- 18 Make suitable
- 19 Havoc unleashed by conflict
- 21 Sleep disturber
- 22 Painter Max
- 24 Make broader
- 25 Court feat
- 30 Like O. Henry tales
- 33 Deceptive move
- 35 Murder
- 36 Longing
- 37 Block
- 38 In the fashion of
- 40 Procured
- 41 Fuming feeling
- 42 Outlaw Kelly



### CRYPTOQUOTE

TSI BSI REE IKQXQ QNTERCRIVBF JBVFIX. RF QNTERCRIVBF JBVEI VX EVGQ ERSKVFRI MBSU BHF LBGQ.

- O. XTBI OVIWAQUREZ

Saturday's Cryptoquote: THERE IS, AFTER ALL, A KIND OF HAPPINESS IN UNHAPPINESS, IF IT'S THE RIGHT UNHAPPINESS.

- JONATHAN FRANZEN

## Yesterday's answer

TACIT CARAT  
ABIDE ALICE  
PUTONWEIGHT  
STY DOS SEE  
AOKAY  
FITIN REBEL  
AVID MORE  
TYPED TEXAS  
SIREN  
SOS SUN WAD  
PUTONNOTICE  
AZURE ROSIN  
TOBEY SEEDY

### A XYDLBAAXR IS LONGFELLOW

One letter stands for another. In this sample, A is used for the three L's, X for the two O's, etc. Single letters, apostrophes, the length and formation of the words are all hints. Each day the code letters are different.

## BEETLE BAILEY

by Mort Walker



## HENRY

by Don Trachte

