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The Use of Taxation Technique as Incentive to Private Investment in Far Eastern Countries 1/

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The Use of Taxation Technique as Incentive to Private Investment in the Far Eastern Countries

I. Introduction

While planned economic development has been the accepted policy of most of the Far Eastern countries, the plans so far formulated are based on liberal principles and do recognise the importance of private enterprise in the economy. For example, in India's Five Year Plan, which is the most comprehensive among the plans hitherto formulated in these countries, of the total investment, including investment in the so-called "unplanned" sector, about fifty per cent is left to the private sector. Public investment, according to the Plans, is not to replace private investment or even to compete with it. Rather is it to supplement private investment and to create basic conditions under which private investment may function more efficiently and more fruitfully. Hence the special emphasis given, so far as the public sector is concerned, on the development of power, transport and communications and on the building up of what is called "social capital" through health services and education. These are lines which, while they are essential for the over-all progress of an economy, would not readily attract private investment because the returns in most cases are not immediate and direct.

Planned economic development whose purpose is to accelerate the rate of growth implies a higher rate of public investment than could be supported by the resources normally available to the government. Larger resources by way of private or public saving have therefore to be secured, if inflation is to be avoided. And where voluntary private saving is inadequate, as it is in these countries, a part of the need for additional resources has necessarily to be covered by additional taxation. Moreover, since there is not enough scope for extension of tax coverage, partly on account of the general poverty of the people and partly on account of administrative limitations, any significant raising of the tax revenue would involve higher rates on larger incomes.

This seems to present a dilemma to these countries. On the one hand, attempts to mobilize domestic resources would involve additional taxation; on the other hand, there is always a risk that higher taxes, in so far as they fall on profits, would act as a deterrent to private investment. However, this dilemma should not be taken too seriously. It is true that the prospective yield that would just induce a businessman to bear additional risks due to investment is a function of the rate of taxation, rising as the tax rate rises; so that investments which are on the margin of profitableness with a comparatively low rate will not be considered worth while as the rate is raised. [1] But since, in the present context, the need for public investment is urgent and since a curtailment of private investment, if it takes place, would tend to release resources for the public sector through the securities market, aggregate investment is not likely to suffer if taxes are kept within limits. So far as old investments are concerned, a tax on profits will directly transfer resources from the private sector to the public sector; and whereas reinvestments in the private sector on replacement and modernisation would depend upon business decisions having some element of uncertainty, resources drawn to the public sector have an assured channel of investment based on a planned scheme of development.

Public investment on developmental projects is motivated by social return, and a part, at any rate, of the expected social return from these projects consists of the benefits that will ultimately accrue to private industry itself; the major lines of development contemplated in the Plans are such as would offer "external economies" to industries in general. It is expected, therefore, that these industries should pay a just contribution to the common exchequer which is responsible for the creation of these economies. Moreover, given the amount of tax revenue to be collected to provide for the needed public saving, to the extent that relief is given to industry, the burden of taxation would perhaps fall upon people who are less able to bear it.

While, therefore, taxes imposed upon private industry should not be such as would cripple business enterprise or to dry up the source of reinvestment in the private sector, the aim of government policy should be to secure an adequate tax revenue as a supplement to the other resources for development, consistently with an equitable distribution of the tax burden between profit-earners and the rest of the community.

1/ Suppose that a firm intends to invest $10,000 on a new undertaking and that the rate of interest at which capital can be borrowed is 5 per cent. The minimum prospective yield that would induce the firm to make the investment is then $500 plus an additional amount, say, $100, to cover the risk of possible loss. If, however, earnings above $500 (net profit, that is,)are liable to income tax, the cover against risk has to be calculated after making allowance for income tax. If the rate of income tax is 25 per cent, the minimum prospective yield will be put at $633. If the rate of income tax is 50 per cent, the necessary yield rises to $700. Which means that an investment costing $10,000 and having an estimated prospective yield of, say, $650, will not be undertaken if the rate of income tax is 50 per cent, while it would be considered worth while if the rate of income tax were 25 per cent only. (See J. R. Hicks, U. K. Hicks and L. Rostas, Taxation of War Wealth, pp.192-3). It is important to recognise, however, that when the taxpayer has the opportunity of deducting the cost of an unsuccessful investment from taxable income, as may often be the case, the deterrent effect of the income tax will be considerably reduced.

These considerations are, however, tempered by the fact that in most of the countries of the Far East enterprise is singularly lacking. In an environment in which there is a general lack of enterprise in the people, some concession, in so far as its quantitative effect on tax revenue is not appreciable, is perhaps justified with a view to giving the investors a sense of security and a feeling that their cooperation is needed for an over-all progress of the economy. The countries of the Far East are in general pursuing a moderate policy in dealing with business income, giving special tax concessions of various kinds with a view to stimulating new investment and to encourage re-investment. In some cases, special facilities are offered to private industry through an adjustment of customs duties. Moreover, to attract foreign investment a policy of non-discrimination is followed in these countries, extending to foreign investors all those concessions that are granted to domestic investors.

In the following sections a brief account is given of the various measures of tax concession that the countries of the Far East have adopted with the object of stimulating private investment. A special reference has been made to foreign investment in view of the important role that it has in the economic development of these countries. For want of adequate data it has not been possible to assess the effect of the concessions on the growth of private investment in these countries, nor has it been possible to measure the cost to the exchequer that the concessions are involving. These deserve special study.

II. Measures of Tax Concession

(a) Exemption from income tax

The most obvious way of stimulating investment through tax concessions is that of exempting profits from income tax. The exemption is usually in regard to profits within a certain percentage of the capital invested, although there are cases of total exemption, too, as in the Philippines and in the government-sponsored corporations in Ceylon. Such concessions are designed to assist new enterprises and are granted during the first few years of their existence.

In India, Section 15c of the Income Tax Act grants exemption from income tax on profits not exceding 6 per cent per annum on capital employed by new industrial undertakings which are run with the aid of power and which employ ten or more persons, or by any concerns employing at least twenty workers, although run without the aid of power. 1/ The Central Government has the power to exclude any particular undertaking from the benefit of the exemption, but no such exclusion has been made so far. The exemption also applies to dividends paid to shareholders by a company

1/ The exemption was originally available only for concerns employing more than fifty persons and using electrical energy.

whose profits are thus exempt. [1/]

New industrial concerns in Pakistan, set up after August 15, 1947, but before March 31, 1955 are exempt from income tax for five years, in so far as the profits of such concerns do not exceed 5 per cent of the capital invested. Exemption is also granted for two years to income from house property built till March 31, 1955.

In Ceylon, as has been already noted, Government-sponsored corporations enjoy total exemption from both income tax and profits tax. Besides, new industrial undertakings started after April 1, 1951, are, for the first three years, laible to tax only on profits exceeding 5 per cent of the share capital. The undertakings, coming under this rule, must be entirely new, must use electrical energy, employ more than 25 persons and start production within three years from April 1, 1951. Encouragement to investment in housing is given by way of a rebate up to 37-1/2 per cent of the income on rents on small houses, rentable at not more than Rs. 50 per month. The rebate is to be granted for a period of five assessment years, commencing April 1, 1949, and is to apply to houses constructed after April 1, 1948.

In the Philippines, new and necessary industries are exempt from income tax for the first four years. In determining the eligibility of a concern for this benefit, the following points are considered: (i) Whether the industry is likely to contribute to the establishment of a stable economy, taking into account the number of similar enterprises already in existence and their total production capacity relative to the size of domestic and export demand for the product; (ii) the import content of the product (it is required that it should be less than 50 per cent); (iii) whether or not it operates on a commercial scale in conformity to up-to-date practices and indicates an ability to survive after the tax exemption is withdrawn.

(b) Exemption from super-tax

With a view to removing a deterrent to inter-company investment, India allows a special concession in respect of super-tax. Section 56A of the Indian Income Tax Act exempts from super-tax the dividends received by a company from its investments in another Indian company. The latter company must have been formed and registered after March 31, 1952, must be entirely new and must be engaged wholly or mainly in one of certain specified basic industries. It must employ more than ten persons in a manufacturing process carried on with the aid of power or more than 20 in a manufacturing process carried on without the aid of power. The benefit is available in respect also of dividends from existing companies on any additional share capital issued for public subscription after February 28, 1953, for starting or increasing the production of one or more of the basic commodities specified.

1/ The profits of such concerns were also exempt from Business Profits Tax which was in existence in India till March, 1949. Business Profits Tax which was introduced in the Indian budget in 1947-48, was a target of criticism, but in view of the budget position, it could not be given up. Abatements were, therefore, liberalised in 1948-49, and the rate of the tax was also reduced. It was finally abolished in the 1949-50 budget.

(c) Rebates on corporation taxes

India allows a rebate of 2 annas in the rupee 1/ in the case of any company with income exceeding Rs. 25,000 which declares and pays dividends in India. The rebate is one anna in the case of public companies which do not declare and distribute dividends in India. This is not a discriminatory measure against foreign companies but is meant to take the place of the super-tax on dividends earned by foreign investors to the recovery of which the Government of India is entitled but which in view of the administrative difficulties had to be given up. Companies with an income less than Rs.25,000 enjoy a rebate of 2 annas.

(d) Liberalisation of depreciation allowances

A concession in respect of income tax can also be given by liberalising depreciation allowances. Amounts set aside as a provision for depreciation of plant, machinery and buildings are always deductible from income liable to tax. Increasing the legally permitted rates of deductible depreciation is, therefore, tantamount to a reduction of income tax rates. It must be noted, however, that while tax concessions of the sort discussed in the last section are permanent in nature, this concession is of a temporary type. The tax that the concern is exempted from is not permanently avoided but merely shifted through time to a future date; the aggregate of all depreciation allowances is not to exceed the original cost of the asset to the tax-payer. The larger the depreciation rate, therefore, the sooner the day arrives when no depreciation allowance at all is deductible from the taxable income. Sometimes, however, an extra allowance is granted, which is not deductible in computing the written down value of the asset. As the purpose is to encourage new investment, the concession is invariably given to newly acquired or constructed plant, machinery and buildings. The liberalization takes two forms: one is a special initial depreciation allowance for the first year of use and the other, an enhanced rate till the entire value of the asset is written off. The special provision of making the extra allowance not deductible for purposes of determining the written down value of the asset is usually seen in connection with the former but not with the latter. In India, buildings and plant and machinery erected or installed after March 31, 1945 are given an initial allowance (not deductible in determining the written down value) in respect of the year of installation or erection. This allowance which is available in addition to the normal allowance is at the following percentages of cost: buildings, commenced and completed between April 1, 1946 and March 31, 1952--15 per cent; other buildings, 10 per cent; machinery and plant 20 per cent.

Special initial depreciation allowances have also been made available in Pakistan and Japan. In the former, initial depreciation is allowed at the rate of 20 per cent in the case of machinery and plant installed, provided it has not previously been used in the country. 2/ This allowance is in

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1/ 1 rupee = 16 annas.

2/ A special depreciation allowance is given in the first year at the rate of 15 per cent on buildings erected between April 1, 1946 and March 31, 1955, and at 10 per cent on all other buildings.

addition to the normal allowance and is not deductible in computing the written down value.

In Japan, initial depreciation on certain modern machines, equipment, et cetera, prescribed by ordinance, is allowed at a rate of up to 50 per cent of the cost of acquisition, for the first year of their use for business purposes. Further, in estimating the depreciation allowance, revaluations of assets have been carried out since 1950 to take care of the post-war inflation.

As for the acceleration of subsequent depreciation allowances, India permits depreciation at double the normal rates in respect of new buildings and plant erected or installed after March 31, 1948 for each of the five assessment years commencing with April 1, 1949 and ending March 31, 1954. The allowance is deducted in determining the written down value. If it is established that the market value of similar machinery on March 31, 1953 is less than the original cost to the assessee, there would be allowed a further sum equal to the difference between the written down value of the asset on that date and the corresponding value computed on the basis of the reduced price. 1/ If the profits are insufficient to cover the depreciation allowances, the balance is carried forward and set off against profits for subsequent years. There is no limit to the number of years for which an unabsorbed depreciation allowance may be carried forward.

In Pakistan too, depreciation at double the normal rates is allowed in the case of plant and machinery installed on or after April 1, 1948 but before April 1, 1955. The concession is available for a period of five years. If the profits are insufficient to cover the depreciation allowances, the balance is carried forward and set off against profits for subsequent years. There is no limit to the number of years for which an unabsorbed depreciation allowance can be carried forward.

In Japan, individuals and corporations are entitled to a depreciation rate amounting to 150 per cent of the normal on such new machines, equipment and vessels as would contribute to the reconstruction of the Japanese economy, and are used in business after January 1, 1951. The benefit is available for a period of three years.

In Ceylon, special allowance is made for 15 per cent of the cost of the plant, machinery and fixtures as were purchased for agricultural and industrial purposes on or after April 1, 1948, of 33-1/2 per cent in the case of buildings for labourers and 10 per cent for other buildings, including factories. These allowances are to be given during five assessment years commencing April 1, 1949.

In order to guard against the abuse of concession regarding depreciation, it is necessary to lay down that such extra amounts should be specifically set aside for replacements and modernisation. This has been done in India in recent years in respect of the steel industry on the recommendation of the Tariff Board.

1/ This is apparently to take care of obsolescence.

(e) Rebate on undistributed profits

It is necessary in the interest of capital formation that profits earned by companies are not entirely disbursed in the form of large dividends. A part of the profits should be ploughed back into industry in order that industries might expand. To encourage such self-financed expansion, incentives may be offered in the form of reduced rates on undistributed profits. To prevent the distribution of large dividends, India introduced in 1946 a complicated system of super-tax at steeply graded rates on dividends above a datum line. These rates were later stiffened. The measure was, however, found unsatisfactory. On the one hand, it did not limit dividends appreciably; on the other hand, the yield of revenue from the source was found to be comparatively small. The government has therefore introduced the system of rebates on undistributed profits; Indian companies distributing dividends in India are entitled to a rebate of one anna in the rupee on their undistributed profits. This concession, in so far as it is effective in limiting dividends, would do one of two things: Either the larger undistributed profits would be utilised for investment, thus helping capital formation in the private sector. Or, as may well happen, they would add to the idle balances in the private sector, thus providing scope for a corresponding amount of public investment through deficit finance without generating inflation.

(f) Miscellaneous

In the Philippines, new and necessary industries are exempt from the foreign exchange tax. The criteria for eligibility for this benefit are the same as those outlined above in connection with the exemption from income tax. Pakistan exempts imported machinery from sales tax and also all investments in approved industrial undertakings from Estate Duty. Japan's net worth tax 1/ is also designed with a view to promoting private investment. This special levy has been introduced as a substitute for a high rate of income tax on higher income groups with the idea that it would discourage investment less than an equivalent income tax. High income taxes operate as a deterrent to investment, whereas a net worth tax, in so far as it is independent of the income from the assets, is neutral in its effect on inducement to invest.

In addition to these measures, special adjustments of customs duties have been made in some countries with a view to promoting private investment. In India, relief is granted in respect of customs duties on imports of raw materials and plant and machinery for industrial purposes on an ad hoc basis. The import duty on most items of plant and machinery has been reduced from 10 per cent to 5 per cent; duties on certain raw materials have been entirely abolished, while those on certain others have been reduced. In Pakistan, capital goods imports are now exempt from customs duty. Also certain other basic requirements of industry are let in either free of duty or at reduced rates. Ceylon also pursues a similar policy of minimising import duties on all developmental goods. In Japan, wide exemptions from import duties are permitted on certain designated essential industrial machinery.

1/ The net worth tax is a tax on the "net worth" of an individual if it exceeds 5,000,000 yens, net worth being defined as the excess of the sum of assets owned by an individual over the sum of his liabilities.

III. Foreign Investment

(a) Non-discrimination

The countries of the Far East welcome foreign investment and are in general pursuing a policy of non-discrimination as between domestic and foreign investors. This is as it should be. Equal treatment to domestic and foreign entrepreneurs in the conduct of their business affairs generally and in matters of taxation in particular is a necessary condition of a favourable investment climate.

In all the countries under review, the tax concessions that are granted to domestic investors are extended to foreign investors, too. There are apparent deviations in one or two cases. For example, in India a slightly higher rate of corporation tax is levied on foreign companies operating through local branches but declaring dividends in the home country. But this is not discriminatory in intent. As compensation for it, while shareholders of companies declaring dividends in India, as well as Indian companies as such, have to pay a super-tax on these dividends, non-resident shareholders of foreign companies declaring dividends outside India are exempted from the Indian super-tax even though the dividends may be out of profits earned in India. Similarly, in the case of Pakistan, companies distributing dividends in Pakistan pay a super-tax of two annas in the rupee, while those distributing dividends abroad pay three annas. 1/ This again is not discriminatory in intent, but is meant to take the place of super-tax on dividends in the hands of foreign shareholders to the recovery of which the government is entitled but which, in view of the difficulties of collection, had to be given up.

However, how far non-discriminatory treatment accorded to foreign investors would by itself attract foreign capital and entrepreneurship to these countries would depend, apart from profitability and security considerations, upon the general level of taxation in these countries, on the one hand, and upon the tax regulations in the capital exporting countries, on the other.

In general the level of taxation in the countries of the Far East is comparatively low and, when account is taken of the various concessions granted, these countries are offering as much inducement to foreign investment as they could unilaterally do. There were misgivings at one stage about the tax system in Japan. It was argued that the level of personal income tax rates in Japan was so high that the country could not attract foreign personnel who were to accompany foreign investments for purposes of management and control. However, the recent reduction of personal income tax rates pursuant to the Shoup Mission recommendations and the application of the net worth tax to foreign nationals in respect only of their net assets in Japan must have eased the situation to some extent. Further, aliens who do not have Japanese domicile but who have been residents in Japan for a year or more are exempt from income tax on earned income or retirement income paid outside Japan during the period 1950-53, whereas aliens who have Japanese

1/ This extra tax of one anna in the rupee applies to "public" companies, i.e., companies whose shares are open to the public. "Private" companies distributing dividends abroad pay only the general rate of two annas in the rupee.

domicile are liable on it. Such aliens are also exempt from income tax on half of their income subject to a maximum of 3,500,000 yens a year if they are employed in foreign-owned corporations engaged in industries designated by the Minister of Finance, or if they are employed in such business or engaged in such profession as promotes the introduction of foreign capital or facilitates the operation of foreign corporations. Besides, the income of aliens and foreign corporations earned in respect of royalties on industrial proprietories, or special techniques and manufacturing formulae and copyrights during the period April-December, 1952, is exempt from the 20 per cent tax normally levied on it. Such incomes earned after January 1, 1953, are to be taxed at a reduced rate of 10 per cent. The rate of income tax on interest and dividends withheld at the source is also reduced from 20 per cent to 10 per cent in the case of aliens and foreign corporations if they acquired the right to such income legally and by the payment of foreign means of payment.

On the whole, therefore, the Japanese tax system provides rather special concessions to foreign investors. However, these concessions, whether general or special, are hardly of any avail if they are offset by the tax regulations that the foreign investors have to face in their respective home countries. This is a matter which involves agreement between the country seeking capital and the country exporting it.

(b) Avoidance of double taxation

It is now internationally recognised that a country in which a certain income originates has a right--and a prior right--to tax it. It is in accordance with this view that tax treaties designed to secure relief from double taxation through a cancellation of the home tax liability at least to the extent to which the incomes are taxed abroad, are being entered into by an increasing number of countries. For example, the tax system of the U.K., one of the largest capital exporting countries in relation to the countries under review, asserts in general the right to tax all incomes of its residents irrespective of where the income originates. This assertion in fact dates back to the time when income tax was first introduced in that country. However, retreats from this general principle have been made from time to time through bilateral agreements. These agreements have the effect of allowing income or profits tax paid by a businessman in the country where his profits are made to be offset as credit against the U.K. tax on the same profits. Vice versa in the case of a foreign concern doing business in the U.K. Under this arrangement, if the overseas rate is equal to or higher than the U.K. rate, the assessee pays nothing to the U.K. Government on incomes earned overseas; if the overseas rate is lower, he pays the difference. Such agreements exist today between the U.K. and, among the countries of the Far East, Ceylon, Pakistan, Malaya.1/ Where such agreements do not exist, provision has been made, since 1950, for unilateral relief. In effect, this provision allows income or profits tax paid by an assessee to a foreign country to be credited against the U.K. tax liability to the extent of 75 per cent if the other country is a member of the Commonwealth and 50 per cent in the case of others.

1/ Negotiations between India and the U.K. have not so far resulted in any agreement.

Basically the U.S. approach is the same as the U.K. approach, namely that foreign income is to be taxed on a parity with domestic income. However, mitigation of a double levy on income derived from sources outside the U.S. is achieved under the U.S. law either through deduction of foreign taxes of all types from the gross income of an assessee while computing his taxable income, or, at the option of the assessee, by allowing him to credit the tax paid abroad against the home income tax.

Treaties and regulations for avoiding double taxation are welcome, as they remove a most serious obstacle to the flow of international investment. Nevertheless, in the present context where the countries needing development are offering special tax concessions to new industries and extending such concessions to foreign investors, the present agreements are clearly inadequate. In so far as the tax treaties in any case require the foreign investors to pay to the home exchequer whatever difference there is between the home tax rate and the foreign tax rate, the tax concessions granted by the capital importing countries are of no avail from the point of view of inducement to foreign investment. It would seem therefore that, if they are to be really effective in promoting foreign investment, the tax treaties should make incomes earned abroad liable to tax only in the country where they originate. Such an arrangement obviously will mean a loss of tax revenue to the capital exporting countries, but it may well prove to be a major contribution to the flow of international investment.