Chapter - III

THE RATIONALE OF INCENTIVES AND ITS APPLICATIONS

3:1 Introduction

Developing countries are in need of balanced growth to the maximum extent within the given political and social framework. The development has to take root in backward regions where chronic unemployment prevails. Non-availability of infrastructure and hesitation on the part of entrepreneurs are the causes for poor development in these areas. To bring about an equitable distribution of industries there is a dire need of offering incentives. The role of incentives in investment decisions has attracted the attention of economist as well as politicians. This chapter traces the theory of tax incentives, its objectives, varieties and its application in the study area.

3:2 The Theory of Tax Incentives

Fiscal economist has studied the effects of taxes particularly the effect of direct taxes on saving, investment and production. As per the theory, taxes reduce the incentive to work. The corollary of this is that the tax reduction may/can increase the incentive to work. When increasing the tax burden leads to dis-incentive effect, it is equally true that reduction in tax should act as an incentive(Brown C.B., 1968).

Musgrave and Musgrave are of the view that imposition of income - tax reduces the net wage rate. This generates an income effect which increases the work effort. However, there is also a substitution effect which reduces the work effort. "There is no a prior basis, on which to judge the direction in which the net effect will go, although it is reasonable to assume that (the work) effort will decline(Musgrave R.A. and Musgrave P.B., 1976). They have concluded and explained with the help of illustration that the effect of a tax incentive is an increase in work effort They have also illustrated, the negative effect of taxes on investment. This in its reverse could be taken as to present the positive effect of tax incentives on investment.

3:3 The Profit Theory of Investment

Expected profits induce new investment. With the application of the neo-classical theory of capital accumulation, Hall and Jorgenson had analysed the investment behaviour of the firm in response to tax incentives(Fromine G., 1971). Tax incentives influence the capital expenditure by a reduction in the implicit rental price of capital. Tax incentives like tax holiday by reducing the tax component increases the marginal rate of return on capital and give stimulates to investment.

3:4 Liquidity Theory or Cash Flow Theory of Investment

The liquidity effect of tax incentives has been emphasised by Coon (Coon R.M., 1971). Tax incentives influence capital expenditure through an increase in the form of internal funds. Such tax incentives like investment allowances, accelerated depreciation etc., increase the supply of internal funds for investments. The cash flow school contains that it is liquidity effect of tax incentives that is important in measuring the impact of tax incentives on investment.

3:5 The Risk Theory of Investment

According to this school, tax incentives reduce the risk of investment in two ways:

(1) They enable the early or quick or quick pay back or recoup of capital assets.

(2) Tax incentives provide internal funds for investment. That part of the funds provided by any investment allowance enable the entrepreneur to invest less of his own capital to the extent of the investment allowance(Bryce M.D., 1965).

3:6 The Infant Industry basis for Investment

To Bryce the income-tax exemption recognised the rationality of infant industry argument, that new industries need to be assisted in improving their profitability in the early years, when the cost are higher and the revenues may be lower than normal(Bryce M.D., 1965). Scitovsky has provided another theoretical justification of tax incentives(Seitovsky, Tibor, 1945). New firms in agricultural economy are likely to have a private marginal productivity lower than their social marginal productivity and a subsidy is economically justified to make up the difference.

3:7 Tax Bounty Thesis

The Marshall-Pigou tax bounty analysis has provided the theoretical base for tax incentives(Marshall and Pigou) To Marshall consumer surplus would be increased by imposing a tax on industries on diminishing returns and paying a bounty to industries of increasing returns. Taxing industries of diminishing returns would raise the marginal supply price. As a result the number of buyers of the product would be reduced and marginal resources would not be reduced. Supply would be produced under better and more economical conditions. Marginal cost of production, would however, increase less than the amount of the tax because of the elimination of less efficient Units.

Subsidies paid to industries of increasing returns would lead to an increasing output, greater than the amount of subsidy. This is because of the lower unit cost. Thus, to Marshall, consumer surplus would be increased as a satisfaction from the consumption of the product of the increasing return industries would be more than the diminution in satisfaction from the loss of output of the diminishing returns industry.

Extending Marshall's analysis pigou has maintained that a bounty would be justified even on permanent basis, whenever the payment added more to the consumer's surplus than the addition to aggregate real costs.

3:8 Rosenstein-Rodan's Theory of Induced Development

This theory provides a theoretical rationale for fiscal incentives for the economic development of the backward areas.

According to this theory the transformation from the pre-industrialisation to industrialisation in an industrialised country does not take place automatically(Rosenstein-Rodan P.N., 1961). Once the first phase is over an appropriate bridge in the form of "postnatal control" is necessary Tax incentives form a part of this policy of post - natal control. In developing backward areas certain outside forces also can exert some influences. A package of fiscal and other incentives constitute a strong force in that framework of regional development.

3:9 Incentives and Investment

The impact of tax incentives on corporate investment has been studied by Gandhi. The willingness to invest depends upon the profitability of investment after payment of tax. The after tax profitability is measured by the difference between the book profit and the tax liability. The tax liability is governed by taxable profits plus statutory tax disallowances minus statutory tax concessions and the corporate tax rate. In the long run the tax treatment of business losses and the provision for the carry forward affect the profitability of corporate investment.

The ability to invest depends upon the availability of internal and external funds. Internal funds depend upon (1) tax depreciation allowance policy (2) the provision relating to tax free reserves and (3) taxation of corporate retentions

3:10 Definition of Tax Incentives

There are two ways of defining tax incentives. One is notional and the other is functional. With regard to the first tax incentives may be defined as "a temporary expedient intended to make investment attractive by temporarily eliminating a normally operable and efficient tax"(Heller J. and Kauffman K.M., 1963). Tax incentives can also be defined as a reduction in the tax burden. The objective is more significant rather than the reduction in tax burden. Further tax incentives should not be considered as mere tax reductions. It refers to tax reduction to accommodate a certain objective.

Tax incentives can also be defined functionally as a calculated reduction in the tax burden which would induce the tax payer to follow or perceive a particular course of action. It is the mechanism by which an attempt is made to divert the flow of investment funds, from activities that have little or no development forces , into activities whose encouragement is important for development. It is a method of allowing capital to flow into the economically desirable channels. To quote Lent(Lent G.E., 1967). "Tax concessions are intended to induce the establishment of new businesses that otherwise would not be established. In the words of Eckstein, "the tax incentive represents an accommodation between government that need high tax rates to finance their vast activities and professional managerial class which is in the business of investing corporate capital. Thus tax incentives are the carrots in the form of tax concessions to attract investment by increasing the profitability of investment(Eckstein D., 1962).

Tax incentives can also be defined as a difference between the effective tax rate and the stipulated or statutory tax rate. It is the difference between the nominal rate and the effective rate.

3:11 Financial Incentives

Financial incentives can also influence the profitability of industry. Financial incentives are in the form of capital subsidy, low interest loans, tax concessions, labour cost, subsidies, depreciation, allowances etc. These financial incentives are called pull factors since they pull the industrial units to backward regions.

3:12 Objectives of Fiscal and Financial Incentives

The different objectives of tax incentives employed in different countries are summarised here. (1) promoting the pioneer industry has been the objective in Ghana, Jamaica, Malaysia, Nigeria and Peru. (2) Tax exemptions are given in Philippines and Mexico for industrial development to meet the domestic demand (3) Development of new industries has been the objective in Cylon, Costarica, India, Indonesia, Israel, Italy, New-Zealand and Pakistan. (4) Development of the basic, semi-basic and secondary industries has been objective in Mexico. (5) Development of manufacturing industry has been the objective in Australia and Argentina. (6) Development of ship building industry has been the objectives in countries like India, Ireland, Kenya, Pakistan and Mexico. (7) Development of small scale and cottage industries have been the objective in India and Phillipines. (8) Development of new and essential products has been the objective in countries like Canada and Mexico. (9) Promoting import substitution industries is another objective (10) Development of expert promotion industries has been the objective in Australia, Cylon, Finland, India, Malaysia and New Zealand (11) Development of backward regions and areas has been the objective in under developed countries like India. (12) Development of public sector enterprises through incentives is a policy in socialist countries. (13) Utilisation of domestic materials has been the objective of tax incentives in countries like Cylon, France and India (14) Promotion of tourism and Hotels, promotion of scientific research have been the objectives in countries like India.

3:13 Incentives and Small Scale Industries

In countries like India the need for the development of small scale industries has been recognised by economist as well as by politicians. The industrial policy provides a specific place for the small industries in economic development. The idealistic school pleads for the promotion of small scale industries as a part of decentralisation measure. Welfare economist are of the view that to relieve the problem of unemployment with the paucity of resources and capital scarcity, pins the hope on small scale industry. The survival and development of small scale industries depends upon the incentives that are offered. Dr. Sandesara in his study of small scale industry has studied three aspects :

a) that the incentive should be capable of producing an enduring impact on the unit.

b) that the number of units in a region, which have availed of the incentive should be fairly large.

c) that the list of such units available are compilable from the relevant records without excessive efforts(Sandesara S.C., 1978).

d) He concludes that there is a case for preferential treatment of this sector by the state.

3:14 Promotional Measures in India

In view of the various socio-economic roles played by this sector, the Government of India, has set up several agencies to assist this sector through schemes of incentives, infrastructural facilities, grants, subsidies, financing, etc. The Industrial policies of 1948,1956,1971,1977,1991 and 1996 underline the need for small Industries Development Programme to enable this sector to acquire sufficient viability, which are discussed.

The various government assistance programmes which are existing include technical assistance, training facilities, industrial estates, export promotion, nucleus plants, subcontracting exchanges, supply of raw materials, marketing assistance, etc. The local small Industries Service Institutes (SISI) help entrepreneurs in the form preparing detailed schemes for setting up the units. The Small Industries Development Organisation (SIDO) prepares schemes and reports containing technical and general information on a wide range of industries. The SISI and its extension centre's goal is to improve the technical skills of the workers and acquaintance of the entrepreneurs with the advanced production and management techniques. The State Governments also provide a lot of facilities with regard to industrial estates, e.g. subsidy on rent for factory accommodation, allotment of sheds on hire-purchase basis, sales tax concessions, rebate on water/power consumption, etc. SIDO extends services to the manufacturers of the export - worthy products in the form of product designing, quality upgradation, standardisation, packaging, allied services, etc. The nuclear plants set up by the government create a new focal point for achieving rapid industrial development by developing ancillary units. National Small Industries Corporation (NSIC) helps the small entrepreneurs to participate in government's hire-purchase programme. Sub-contracting exchanges act as an information house for matching the requirements of medium and large undertakings looking for sub contractors with the small scale units. The supply of raw materials is the responsibility of SIDO to see that the units do not suffer for want of raw materials.

The sector has been given a number of incentives, primarily in the form of fiscal concessions, and, to a certain extent, in the form of financial benefits. The Central Government provides tax incentives to the entrepreneurs in the following ways(Anjana Chatterjee, 1991).

A. Income Tax Concession : Concessions in the form of deduction of 20 percent of the total income for the initial ten years. For availing these concessions, the small units should be established in rural areas which cover:

a) An area within the jurisdiction of a municipality or cantonment board having a population of not less that 10,000 according to the last census, and b) An area not being more than 15 Kms, from the local limit of any municipality.

B. Income Tax Holiday Concessions : Such industries are exempted for a period of five years from I.T on their income upto 6 percent of the capital employed. For the exemption, the undertaking must satisfy certain conditions.

a) It is not formed by the splitting up or reconstruction of an existing business;

b) It is not formed by transfer to a new business of building, machinery or plant previously used for any purpose; and

c) This benefit will not be available to those undertakings which belong to non-priority items.

C. Excise Duty Concessions : A small unit whose value of sale does not exceed Rs.15 lakhs per annum (Rs.30 lakhs where the unit is manufacturing more than two products) is completely exempted from payment of excise duty. For sale between Rs.15 lakhs and Rs.75 lakhs, the small scale unit is required to pay excise duty at a concessional rate of 10 percent subject to a minimum duty of 5 percent advalorem.

D. Tax incentives for Exports : The small units are allowed a deduction of 100 percent of the profits derived from the export of such goods provided the sales of these goods are receivable in convertible foreign exchange.

E. Investment Deposit Account Scheme : Under this scheme, the small - scale units are allowed a deduction from the profits of any business engaged in the manufacture of goods of low priority items to the extent of the amount deposited upto 20 percent of the profits. Also, the deduction is allowed if the amount is deposited in a development bank, e.g. IDBI, before the expiry of six months from the end of the previous year. The account of the business should be audited and the amount deposited with the account shall not be allowed to be with drawn before the expiry of a period of five years except in case of:

* Death of an assessee
* Dissolution of the firm
* Partition of a Hindu undivided family.
* Liquidation of a Company.

F. Modified Value Added Tax (MODVAT) : This allows the manufacturers to obtain instant and complete reimbursement of the excise duty paid on the components and raw materials. The scheme avoids the payment of duties on earlier duties paid on raw materials and components (for the final product).

3:15 Financial Assistance(Anjana Chatterjee, 1991)

Many financial institutions like the National Small Industries Corporations (SSICs). State Financial Corporations (SFCs), State Directorates of Industries, and IDBI provide long-term loans at low rate of interest for the period of 5-15 years against mortgage of assets such as land, building, plant and machinery, etc. The short-term loans are generally arranged by way of bank credit, overdraft facilities, discounting of bills, bills of exchange, and so on. Advances are provided to the small entrepreneurs by government agencies, SFCs and other financial institutions. The various assistances provided by the financial institutions are two - fold schemes, viz.

a) Financial Subsidy Schemes:

* Adoption of Indigenous technology
* Interest subsidy for women entrepreneurs
* Meeting cost of market studies
* Promotion of ancillary units;
* Revival of sick units;
* Encouraging modernisation
* Control of Pollution in industrial units.

b) Other Assistance Scheme:

* Development of technology;
* Self-development and self-employment
* Risk Capital
* Margin money scheme
* State aid/loan
* State financial corporation
* Commercial banks
* Credit guarantee Schemes; and
* Machinery on hire - purchase.

3.16 Incentives Offered by the Government of Tamil Nadu

With the objective of fostering the pace of industrialisation and to enhance the competitiveness of Tamil Nadu for attracting larger share of industrial projects, Government of Tamilnadu has launched its New Industrial Policy in January, 1992 in the new era of Economic liberalisation encompassing the entire gamut of industrial development. This policy framework enunciates the guiding principles besides offering a liberal package of fiscal incentives.

Government of Tamilnadu offers a range of incentives as mentioned here under:

1. Backward & Most Backward Area Capital Subsidy
2. Special Investment Subsidy for Thrust Industries
3. Capital Subsidy for Tourism Projects
4. Women Employment Subsidy
5. Pioneer Industries Special Subsidy
6. Generator Subsidy.
7. Mega projects Subsidy
8. Concessional Power Tariff
9. Effluent Treatment Plant Subsidy
10. Sales Tax Waiver
11. Interest Free Sales Tax Deferral Scheme(Govt. of Tamilnadu, 1994).

3:17 Capital Subsidies

1. Investment Subsidy will be given at the rate of 20% on fixed assets subject to a maximum of Rs. 20.00 lakhs for all new industries set up in 31 most backward taluks and SIPCOT Industrial complexes at Pudukkottai, Manamadurai and Tuticorin.

2. Investment subsidy will be given at the rate of 15% on fixed assets subject to a ceiling of Rs.15.00 lakhs for new Industrial set up in 82 backward taluks of the state and in all industrial estates and other complexes developed by the government agencies.

3. A higher rate of investment subsidy will be extended to certain thrust industries set up in 82 backward taluks of the state and in all industrial estates and other complexes developed by the Government agencies.

4. A higher rate of investment subsidy will be extended to certain thrust industries located anywhere in state.

* Electronics - 20% of fixed assets subject to a maximum of Rs. 35.00 lakhs.
* Leather - 20% on fixed assets to a maximum of Rs. 20.00 lakhs.

5. A special capital subsidy of 10% of fixed assets subject to a ceiling of Rs. 15.00 lakhs will be extended to medium and large industries set up anywhere in the state in the following categories.

* Automobile spare parts
* Drugs & Pharmaceuticals

* Solar Energy and other non-conventional energy devices

* Pollution control equipment

* Export oriented gold jewellary making and diamond processing unit.

* Jute industries in specified areas

* Sport goods and accessories

* Food processing industries

* Cost effective building materials like Aluminium or PVC doors,window frames etc.

Small scale industries units in the above thrust industry groups are eligible for the above special capital subsidy at a higher rate of 20% of fixed assets subject to a maximum of Rs. 15.00 lakhs irrespective of their location.

6. Tourism has been declared as industry.

7. New Industrial units which employ more than 3Kg women in their work force will be eligible for an additional subsidy of 5% upto a ceiling of Rs. 5.00 lakhs.

8. A pioneer Industries Capital Subsidy of Rs. 25.00 lakhs will be given to new units with a fixed capital investment exceeding Rs. 5.00 crores in a single project proposal being set-up as a first unit in declared backward and most backward areas.

New units with fixed capital investment in eligible fixed assets in a single project proposal exceeding Rs. 25.00 crores being set up anywhere in Tamil nadu as also existing industrial units expanding and / or diversifying with an additional fixed capital investment in a single project proposal exceeding Rs. 25.00 crores, made after 1.10.1988 will be eligible for higher capital subsidy of Rs. 25.00 lakhs.

9. In order to encourage units to have reliable power supply, subsidy for installation of new generators for captive use to the extent of 15% of cost upto a ceiling of Rs. 5.00 lakhs is also extended.

10. A power supply with following tariff concession has been introduced for new industries set up in Tamilnadu

1st year	40%
2nd year	30%
3rd year	20%

11. Effluent treatment plant subsidy :

A special subsidy of 10% of the value of assets created towards setting up of effluent treatment plant with a ceiling of Rs. 2.00 lakhs will be made available for installation of effluent treatment plant by the existing tanneries.

12. The above subsidies are extended to existing industries undertaking expansion/diversification without any limit to the number of such expansions/diversifications. The envisaged additional turnover of such expansion/diversification should be at least 15% increase in existing turnover of the company undertaking expansion/diversification (Govt. of Tamilnadu, 1994).

3:18 Sales Tax Concession

New units set up in 31 most backward taluks in the state are eligible for full waiver of Sales Tax dues for a period of 5 years or deferral for 9 years subject to a ceiling of total investments made in fixed assets.

Existing industrial units undertaking expansion in most backward taluks and above industrial estates/ complexes are also eligible for the above concessions of waiver/deferral.

New Industrial units set up in 82 backward taluks, SIPCOT industrial complexes at Gummidipoondi, Cuddalore, Hosur & Ranipet, Industrial Estates promoted by SIDCO, Directorate of Industries, MMDA & MEPZ are eligible for sales tax deferral for a period of 9 years subject to a ceiling of 100% investment made in eligible fixed assets.

Existing units in the above areas undertaking expansion/diversification are eligible for deferral of sales tax for 9 years subject to a ceiling of 80% of the additional investment made in fixed assets.

New units set up in other areas (industrially forward) will be eligible for deferral of sales tax for years subject to a maximum of 60% of total investment made in fixed assets.

Existing units undertaking expansion in other areas (industrially forward) are eligible for deferral of sales tax for 5 years upto 50% of the additional investment in fixed assets made(Govt. of Tamilnadu).

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Chapter - III

Paragraph	Line	As it is	As it should be
Second	I	Source	Gandhi Ved P. - "Some aspects of India's Tax Structure" - An Economic Analysis vora & Co 1970.
Third	II	SSICs	NSICs
Seventh	I	3 Kg	300
Fifth	II	for years	for five years