CHAPTER - II

A SURVEY OF THE PATTERN OF INVESTMENT ALLOWANCES AND ITS IMPACT ON INDUSTRIAL GROWTH IN COUNTRIES OTHER THAN INDIA.
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The scheme of Development Rebate is nothing peculiar to India alone. Many other countries of the world suffered from Industrial recession or stagnancy in the same way as India did owing to the hindrances in the replacement of worn out capital-assets created by rise in prices. Tax incentives for industrial development were, therefore, introduced in one form or another in those countries in a similar way because charging excess depreciation on replacement cost basis did not enjoy any tax allowance in those countries as well.

The U.K.

The fiscal policy of the U.K. has always been geared to stimulating growth, expansion and modernisation of industries in the country. Consequently, the U.K. industries have been enjoying tax concessions in one form or another for a long period of time.

With the end of the Second World War, the need for a kind of tax incentive in order to maintain or increase the tempo of industrial enterprise was widely felt in the country when replacement of worn-out assets was considered necessary. The Income Tax Act of 1945 provided, over and above other statutory allowances, Initial Allowance to enable the industrial enterprises to undertake re-equipment.\footnote{H.B.Rose: The Economic Background to Investment; Syndics of the Cambridge University Press, London, 1950, p.218.}
Although Initial Allowance was designed to provide an incentive to the industrial sector for modernisation, it did not seem to be the best answer to the problem of re-equipment under conditions of stagflation witnessed during the fifties. During this period, both the growth rate and the industrial production were found to be slow or declining while prices were found to be rising. The industrial entrepreneurs found it difficult to carry out replacement of worn-out assets and modernisation insofar as total depreciation allowed for tax purposes was limited only to the original cost of an asset. Consequently, certain improvements in the tax system were considered necessary to create a favourable environment for maintenance, growth and expansion of the industries of the country. This ultimately led to the introduction of Investment Allowance for the first time in the country in 1954. Initial allowances were, however, allowed to continue.

Investment Allowance was, in fact, in the nature of bonus to industry insofar as more than the total cost of an asset was made available to industry by way of depreciation allowances for tax purposes during the life span of the asset. Moreover, Investment Allowance did not reduce the cost of an asset for calculating annual depreciation allowed for tax purposes. Over and above

6. Ibid., p. 195.
Initial Allowances (though operated on a restricted scale in a number of cases after the introduction of Investment Allowance), Investment Allowances were 10% for industrial buildings, 20% for mining works, 20% for new machinery and plant, 10% for dredging works in docks or harbours, 40% for new ships, 20% for scientific research and 20% for heat insulation and fuel saving equipment.

In 1956, the area of the operation of Investment Allowance was, however, reduced and it was allowed to operate on a restricted scale. The partial withdrawal of Investment Allowance was due to its considerable success in stimulating investment which gained a reasonable height.

In 1966, Investment Allowance was converted into Investment Grants, a much more generous form of tax subsidy. It was in the nature of a cash benefit on capital expenditure and the grants were available at 20% of the capital cost at the national level and at 40% of the capital cost in the Development Areas.

In 1972, the system of Investment Grants was replaced by Initial Allowances enabling the industrial sector to write off, for tax purposes, the full value of machineries against profits in

13. Ibid., pp. 56 and 58.
the year of their acquisition. The tax law also provided Initial Allowances for industrial buildings at 40% of the cost (subsequently raised to 54% with an annual writing down allowance at 4%). The Industry Act of 1972, in addition, provided a new system of regional investment incentives known as Regional Development Grants at 20% or 22%. While introducing the Regional Development Grants Mr. Barber, Chancellor of the Exchequer, referred to them as "investment allowances" in his budget speech and the system, in reality, is similar to that of Investment Grants. Moreover, the Grants do not reduce the value of an asset eligible for other allowances for tax purposes.

To sum up, the tax law of the U.K. provides, at present, a generous system of industrial incentives in order to facilitate a reasonable rate of industrial growth and development in the country. 100 per cent initial allowances are made available for plant and machinery and 54 per cent for new industrial buildings and structures with an annual writing down allowance at 4%. There are, in addition, Regional Development Grants at 20% or 22%. The separate tax law in Northern Ireland provides 30% or 40% capital grants to manufacturing, construction and extractive industries to meet the cost of new buildings, machinery and equipment.

Other West European Countries - a few examples:

(a) West Germany

The Government assistance is extended to industry in the shape of tax deductible allowances or subsidies and depreciation at higher rates. The 7½% investment grant which has been made available to the industrial sector has stimulated industrial investment in the country to a very significant extent.

(b) France

An incentive of 20% Equipment premium, besides depreciation and other allowances, was made available to industry during the fifties. The rates of depreciation allowances to total gross fixed investments was found to be 40% during the sixties.

Various capital grants are, at present, made available to industries of the designated regions. The grants include 15 per cent or 25 per cent of the total amount of investment spending required for the purpose of setting up of a new factory and 12 per cent of the cost of extension undertaken by an established factory.

In addition, grants at 10% of administration costs, 13% of research study costs and 20% of transfer costs of headquarters are also available to industries.

21. Ibid., p. 25.
23. Ibid., p. 139.
25. Ibid., p. 53.
(c) **Sweden**

Investment allowances were granted to industries in Sweden in 1964 and operated up to 1972. At present, the industries are allowed 40% of profit before tax by way of deduction for tax purposes if the amount is set aside in the shape of an investment reserve fund for replacement of assets. Moreover, the companies and firms are allowed a further deduction of 10% of the amount withdrawn from the fund for replacement purposes. The tax deductions thus reach a figure almost equivalent to 110% of the cost of the asset acquired. This investment funds policy produced salutary effects inasmuch as the private investment spending has been stimulated to a remarkable extent.

Subsidies ranging from 10 per cent to 35 per cent of capital costs are also made available to industry.

(d) **Austria**

The growth laws of Austria include, besides special depreciation allowance, a system of advance write off ("Bewerlungsfreiheit" procedure) in respect of fixed investments undertaken by industries. The system has exercised "salutary influence on investment" in the country. A complementary device also exists.

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27. Ibid., p.98.
28. Ibid., p.98.
29. Ibid., pp.100-101.
30. Ibid., pp.79 and 221.
33. Ibid., p.52.
as a tax-free investment reserve\(^34\). An amount equivalent to 20% of profits set aside as an investment reserve is exempt from tax. In addition, subsidies are made available to industries in development areas\(^35\).

(e) Belgium

Accelerated depreciation together with temporary provisions for investment allowances are found to operate in Belgium\(^36\). Moreover, the fiscal policy of 1975 has provided for deduction from personal income tax or company tax an amount equivalent to 15% of the cost of additional investment undertaken in business premises and equipments\(^37\).

In countries like Luxembourg, Netherlands, Italy, Switzerland, Portugal, Ireland, Spain, Denmark, Finland and others such incentives as accelerated depreciation, investment allowances, depletion and tax exemptions are made available to industries to stimulate industrial investment\(^38\).

\(^{34}\) Ibid., p.52.

\(^{35}\) Ibid., p.157.

\(^{36}\) Federation of British Industries: Taxation in Western Europe; London: op. cit., pp.36-37.


\(^{38}\) a) Federation of British Industries: Taxation in Western Europe; London - op. cit., pp.51-52; 59-60; 101; 109; 127-128.
The U.S.A.

The principal allowance, provided by the tax law in the U.S.A. to stimulate investment, is a credit allowed against tax. This system is a departure from the usual method of allowing deductions from pre-tax profits as is found in many other countries. This system of incentive, known as Investment Tax Credit, was first provided by the U.S.A. tax law at the rate of 7% for capital expenditure in 1962. The normal deduction by way of depreciation, permissible to the firms for the tax purposes, was, however, allowed to continue. The net result accruing from this tax incentive is to increase the present value of an investment that a firm will undertake.

The primary objective underlying the introduction of Investment Tax Credit is, in practice, two-fold. Firstly, this kind of tax credit will stimulate the investment incentives of the prospective entrepreneurs and secondly, it will widen the capacity of the existing business units to generate enough of industrial funds, a large part of which, can be reinvested in the business. The provision for Investment Tax Credit was


introduced in the country at a time (i.e. in 1962) "When the economy of the United States was lagging behind .... it was meant to spur lagging replacement and net additions to capital in order to increase the national growth rate". The tax incentive was abolished by the Congress in 1969 when there was a sharp rise in prices and the investment level gained a considerable height. But the termination of Investment Tax Credit acted as one of the positive deterrents to the investment activities and the industrial production soon registered a downward trend. Moreover, a large number of "manufacturing corporations reported losses". The condition of business liquidity appeared very gloomy and alarming and it actually created a "growing public concern". It was admitted by all concerned that the withdrawal of Investment Tax Credit along with increases in the rates of different taxes for inflation control in accordance with the Tax Reform Act of 1969 "raised tax burden of investment, through higher levies on corporate profits, and thereby reduced both the supply of internal funds available for business investment and the incentive to invest". The need for such a fiscal policy as would be capable of playing its part in entirety was finally recognised by the U.S. Government. Investment Tax Credit was, therefore, considered indispensable by the Nixon Administration for the creation of a favourable environment for the improvement of the industrial

42. Ibid., "Introduction" by Gary Fromn; p.2.
44. Ibid., p.177.
45. Ibid., p.90.
activities. This ultimately led to the reintroduction of Investment Tax Credit in 1971. But the U.S. Economy was soon found to be in the grip of galloping inflation and recessionary trends were also noticeable along with it. Inflation was found to reach its peak in 1973 and the contractionary monetary and fiscal policies as designed to fight inflation were, perhaps, largely responsible for the recessionary trends that were found to all the U.S. economy for a considerable period of time. Production and employment registered a sharp fall while a considerable increase in inventories could be witnessed.

What caused real concern to the U.S. industry was that the inflation badly affected the financial positions of the companies by distorting corporate profits. The prices of materials rose considerably causing a large increase in inventory profits while real cashflows were found to be "stagnant or falling". This state of affairs caused overstatement of profits of the companies resulting in a considerable increase in their tax liabilities. The easier monetary policy, as pursued by the Federal Reserve System in order to free the U.S. economy from the trouble it was put to, could not produce any desired results.

Faced with this situation, the U.S. Government, in order to reverse the falling trend of production and employment, found no

48. Ibid., p.20.
49. Ibid., p.21.
50. Ibid., p.21.
alternative but to bring about a significant change in the fiscal policy in July, 1975. Investment Tax Credit was increased from 7% to 10%^{51}.

Canada

The federal law of Canada provides various types of assistance for stimulating growth, development and modernization of the industrial sector of the country.

Accelerated depreciation allowances \(^{52}\) (write offs in two years) are made available to industries by the federal tax law. Moreover, certain industries are also allowed to deduct every year, besides accelerated depreciation allowance, an amount equivalent to 30 per cent of development costs and new mining industries are entitled to write off immediately the entire costs of capital equipments\(^{53}\).

One of the major tax incentives, Investment Allowance, has now been converted into a more generous form of assistance, i.e. capital grants\(^{54}\).

There are various grants made available to industries and other firms. Government financial assistance to companies includes,

51. Ibid., p. 34.
52. Canada Year Book 1975: Minister of Industry, Trade & Commerce; Chief Statistician of Canada; Ottawa, Dec. 1975; p. 780
53. Ibid., p. 780.
54. George E. Lent: "Tax Incentives in Developing Countries" in Richard M. Bird & Oliver Oldman (Editors) - Readings on Taxation in Developing Countries; op. cit., p. 365.
amongst others, 50% of development costs under PAIT (Program for the Advancement of Industrial Technology) 25% of capital expenditure under Development Incentives Act and 50% of the project design cost under Industrial Design Assistance.

Under the Regional Development Incentives Act of June 1969 (amended in December 1970) grants are made available to industries in designated areas for their growth, expansion and modernization. These grants include benefits of 25 per cent of capital costs and an amount varying from $5,000 to $30,000 for each job created. Small industries in certain regions are given direct financial assistance or benefits of deductions of investment costs from incomes by the provincial governments. The small industries, in such cases, receive, besides other benefits, grants of 100% of the costs of buildings and 75% of the capital costs of machineries.

The federal law also provides indexation of tax system in order to eliminate the unfair increases in the tax burden.

56. Ibid., p.651.
57. Ibid., p.663.
60. Canada Year Book 1975; op.cit., pp.666 and 668.
61. O.E.C.D: Canada; Director of Information; Paris, June, 1975; p.27.
caused by inflation by increasing accounting profits of the firms without increasing their real incomes.

Japan

Japanese industry has, in fact, been receiving, besides tax incentives, various forms of direct financial assistance from the Government since Meiji Restoration. The relationship between industry and Government in Japan has been viewed as "being that between hand and glove." The Government assistance to Japanese industry includes outright grants for purchasing machineries, equipments and importing raw materials, tax deductions and special depreciation allowances (upto 50% of the capital costs in the first year) and loans "made at rates concessional enough to classify them as subsidies." 

The effects of the direct financial assistance of the Government and various tax incentives appear to be quite dazzling insofar as the following table 64, gives an idea as to how Japan has been able to outrank principal industrial countries in terms of rate of growth:

<table>
<thead>
<tr>
<th></th>
<th>1950-50</th>
<th>1960-70</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>9.1%</td>
<td>11.3%</td>
</tr>
<tr>
<td>West Germany</td>
<td>7.9%</td>
<td>4.7%</td>
</tr>
<tr>
<td>France</td>
<td>4.5%</td>
<td>5.6%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2.8%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Italy</td>
<td>5.6%</td>
<td>5.7%</td>
</tr>
<tr>
<td>United States</td>
<td>3.2%</td>
<td>4.2%</td>
</tr>
</tbody>
</table>


63. Ibid., pp. 38 and 46.

64. Ibid., p. 3.
Australia

Incentives provided by the fiscal policies of Australia include, besides depreciation allowances and other tax reliefs, out-right grants, subsidies and bounties to industries and other firms.65.

One of the main incentives provided to manufacturing industry was Investment Allowance66 which was introduced in 1962 in order to stimulate investment and operated up to 1973. The measure allowed a deduction of 20 per cent of capital expenditure incurred on acquiring plants and machineries. Investment Allowance has now been replaced by grants and subsidies which are made available to industries and other firms at the rates varying from 33\(\frac{1}{3}\)% to 45% of capital investment undertaken by them67.

New Zealand

New Zealand has adopted a number of tax incentives to stimulate industrial investment in the country.

In addition to special and additional depreciation allowances, an investment allowance to industries at 10% of the costs of new plant and machinery at the national level and at 20 per cent in specified areas is found to operate in New Zealand.68.

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66. Ibid., p.31.
67. Ibid., pp.67-89.
Less Developed Countries - a few examples:

Although industries in the developed countries owe a considerable part of their growth and development to tax incentives made available to them, yet it has been admitted that tax incentives employed in the developed countries do not, in certain cases, favourably compare with those of certain developing countries. It has been pointed out that "some developing countries have so greatly expanded the scope and size of tax benefits that those of the United States seem to pale in comparison." Incentives like tax holidays, investment allowances, accelerated depreciation and partial or complete exemption from various taxes for definite or indefinite periods are found to operate in developing countries.

The tax incentive provided to industry by Singapore tax laws are designed to build up a strong economic foundation of the country. Besides generous depreciation allowances the economic Expansion Incentives (Relief from income tax) Act provides exemption from tax for 5 years and in some cases, the period runs up to 15 years and allowances by way of special deductions in respect of plant and machinery acquired for expansion of factories are allowed to industry.

69. George E. Lent: "Tax Incentives in Developing Countries" in Richard M. Bird and Olivier Oldman (Editors) - Readings on Taxation in Developing Countries: op. cit. pp. 364-365.
70. Ibid., p. 369.
71. Singapore '73: Publicity Division, Ministry of Culture, Singapore; p. 119.
Countries like East Africa, Malawi, Rhodesia and Turkey are found to adopt the pattern of allowances granted to industry in the U.K.\textsuperscript{72}.

In Morocco, 20\% capital equipment bonus is made available to industry\textsuperscript{73}. Some countries like Malaysia, Nigeria, Togo, Nepal, Jamaica, Puerto Rico, Pakistan, Bangladesh and Senegal have adopted the system of tax holiday which runs for a definite or for an indefinite period\textsuperscript{74}. The definite period may run even up to 17 years. Some of these countries are also found to adopt the method of reinvestment and special depreciation allowances\textsuperscript{75}.

Tax incentives including investment and reinvestment allowances together with grants are made available to industries in Argentina, Bolivia and Ecuador\textsuperscript{76}.

The new companies of Brazil are exempt from income tax and customs duty for a considerable period of time which may run up to several years\textsuperscript{77}. In addition, a novel system of

\textsuperscript{72} George E. Lent: "Tax Incentives in Developing Countries" in Richard M. Bird and Oliver Oldman (Editors) - Readings on Taxation in Developing Countries; op.cit., p.367.

\textsuperscript{73} Ibid., p.367 and 374.


b) George E. Lent: "Tax Incentives in Developing Countries" in Richard M. Bird and Oliver Oldman (Editors) - Readings on Taxation in Developing Countries; op.cit., p.367.

c) Paul L. Cheng-Young: "Evaluating Tax Incentives : The case of Jamaica" in Richard M. Bird and Oliver Oldman (Editors) - Readings on Taxation in Developing Countries; op.cit., p.379.

\textsuperscript{75} George E. Lent: "Tax Incentives in Developing Countries" in Richard M. Bird and Oliver Oldman (Editors) - Readings on Taxation in Developing Countries; op.cit., p.374.


\textsuperscript{77} George E. Lent: "Tax Incentives in Developing Countries" in Richard M. Bird and Oliver Oldman (Editors) - Readings on Taxation in Developing Countries; op.cit., p.375.
tax-funds created out of deposits of half the amount of tax liabilities by the companies in the Bank of North-east of Brazil or Amazon Credit Bank is found to operate in the country. The system has met with unique success in rapidly increasing new industrial investment in the private sector.

To sum up, the system of tax incentives is being looked upon by all the countries as an effective means for stimulating industrial growth and expansion. In this context, it has been observed that "one degree or another all countries employ tax incentives to promote domestic investment...." 79.

At this stage, it should be admitted that in recent times the relevant information relating to tax incentives of all countries and developing countries in particular, are not fully available. It has been pointed out in this connection that although there are various tax incentives for stimulating capital investment but "no details on the concessions granted are publicly available" 80.

Now, a pertinent question may, however, arise as to why tax incentives are found to operate in different countries to neutralise the effects of inflation, while the accountants have devised tools and techniques for inflation accounting. The

78. Ibid., p.375.


present study, therefore, makes an attempt in the following chapter to examine the propriety or otherwise of the argument of the industrial sector in favour of framing a suitable method of inflation accounting for neutralising the effects of rising prices on historical cost accounts.