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EFFECTS OF TAXATION ON BUSINESS IN LESS DEVELOPED COUNTRIES WITH SPECIAL REFERENCE TO SRI LANKA

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THESIS SUBMITTED IN FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF DOCTOR OF PHILOSOPHY

UNIVERSITY OF WARWICK

SCHOOL OF INDUSTRIAL AND BUSINESS STUDIES

OCTOBER 1981

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Acknowledgements

I owe a great debt of thanks to many people both in the University of Warwick and in the firms participating in the surveys. In particular I wish to thank Professor Roger A. Fawthrop, my supervisor, for making it possible for me to undertake the research, for financial assistance in conducting the surveys, and for help and advice in the preparation of the thesis. I also thank my brother, Chandra Jayaratne, and Mr. Rajan Asirwatham for assistance in gathering data in Sri Lanka. I am most grateful to Mrs. Bernadette Woutersz for handling the secretarial work on the Sri Lankan surveys and to Mrs. Peta McAllister for typing the thesis. I thank my husband for his unfailing support.

Abstract

Taxation today plays a major role in economic activity, as the prime source of revenue and as a tool of economic management for government and as a major recurrent outgoing for business firms and households.

Theoretical analysis of the impact of new taxes or changes in taxation is usually conducted with reference to investors and business firms exercising 'rational' profit (or present value) maximising behaviour under conditions where all other relevant factors remain unchanged. Empirical evidence on business response to taxation is however inconclusive in the case of developed economies and sparse in relation to LDCs.

This thesis examines the impact of taxation on business in LDCs at the level of the individual business firm, using the survey technique supported by content analysis and ratio analysis of published material. The study is carried out with particular reference to Sri Lanka, a typical LDC, but the findings are also supported by analysis of business opinion in two other developing countries. A separate examination is undertaken of the perceptions of and responses to taxation of MNC business operating in LDCs.

The research results lead to three main conclusions. Firstly, the perceptions of business relating to taxation are seen to be non-uniform and for the most part are related to organisational characteristics of the business entities.

Secondly, business response to taxation does not always correspond with rational profit maximising behaviour on the part of business managers. Liquidity objectives appear to be at least as important.

Finally, perhaps the main conclusion drawn from the research findings is that the impact of taxation on business decisions is small and that taxation is not by any means a major constraint on business development; the main reason being the presence of other more restrictive environmental influences.

ABBREVIATIONS

ABIC	Association of British Interests in Ceylon
ACT	Advance Corporation Tax
BTT	Business Turnover Tax
CRA	Convertible Rupee Account
d.f.	degrees of freedom
DCF	Discounted Cash Flow
DFCC	Development Finance Corporation of Ceylon
DTR	Double Taxation Relief
FEEC	Foreign Exchange Entitlement Certificate
GNP	Gross National Product
IRR	Internal Rate of Return
LDC	Less Developed Country
LSD	Lump Sum Depreciation
LSSP	Lanka Sama Samaja Party
NNC	Multinational Corporation
NPV	Net Present Value
PAYE	Pay as you earn
RCE	Return on Capital Employed
SL	Sri Lanka
SLFP	Sri Lanka Freedom Party
UF	United Front
UNP	United National Party
VAT	Value Added Tax

Note: Abbreviations used for ratios in Chapter 11 are explained in Appendix 17.1

INTRODUCTION

Taxation is a major factor influencing business activity in the modern world. Not only is a significant proportion of resources of business transferred regularly to the government or governments under whose jurisdiction a business organisation operates, but it is also true that the manner in which the transfer takes place and the proportion of resources transferred are not uniform as between countries, or even within a single country as between different business activities or as between different types of organisation. In the post-war period, fiscal systems the world over have grown and become ever more complicated with a multiplicity of taxes and numerous allowances, disallowable items and incentives for development of preferred business activities. Taxation then is not a neutral levy; and planning for tax minimisation is an essential part of efficient business management. Hence, an understanding of the impact of taxation on business is of considerable interest to both the academic analyst and the business manager.

From the standpoint of government, taxation is a major (perhaps the main) source of revenue, and tax policy is one of the instruments that may be used in the regulation of the economy. Fiscal policy makers are frequently called upon to balance revenue needs with other socio-economic objectives in the formulation of tax regulations and, in carrying out this task, an understanding of the perceptions and responses of taxpayers to various tax measures, past and proposed, is an important prerequisite. Business organisations are the major institutional taxpayers in any country: hence an insight into their response to taxation is particularly valuable.

Economic theories concerning the impact of taxation on various aspects of taxpayer activity have been empirically tested over the years both by means of surveys and by analysis of macro-economic variables. Much of the empirical evidence so accumulated is, however, in respect of industrialised countries and there is relatively little published material on the impact of taxation in less developed countries (LDCs). Given the dissimilarity between developed countries and LDCs in many characteristics influencing tax policy and/or taxpayer behaviour, such as their institutional infrastructures, taxable capacity and the typical types and scale of business activity, it cannot reasonably be taken for granted that empirical observations made in developed countries will apply equally to LDCs. Independent confirmatory evidence from LDCs regarding tax policy/taxpayer interactions is needed. This thesis examines the effect of taxation on business development mainly with reference to a particular LDC - viz., Sri Lanka (SL).

Turning to the specific case of SL, two documents dealing at least partly with the impact of taxation have been published to date - viz., the reports of the Taxation Commissions of 1955[179] and 1968.[180] Both these commissions were fairly restricted in their terms of reference, and had as one of their objectives the 'promotion and development of new sources of revenue'. Though the commissions did collect evidence from the tax-paying public, only the reports of the commissioners have been published, and these only partially and indirectly assess the impact of certain taxes being charged at the time. Hence, for SL, there is very obviously a need for current empirical evidence on the effects of taxation on business activity.

It is necessary at this early stage to acknowledge that some of the terms incorporated in the title of the thesis are open to more than one interpretation and to define the meanings attached to these terms in this work.

Firstly, taxation is a compulsory levy that may be charged at many levels of government: it may be levied by central government, by state governments in federated states or by local authorities at county or district level. For our purposes, however, taxation considered would be restricted to central government taxes; interest being focussed exclusively on taxes - both direct and indirect - falling on business organisations either as legal entities or in the persons of their owners.

Business for this purpose is defined to include all entrepreneurial activity in the private sector and to exclude such activity undertaken by the government or state owned corporations.

Definition of an LDC is rather more difficult. In the literature, the concept of underdevelopment is vaguely defined and many different indicators of the level of development of nations have been suggested; such as the level of per capita GNP, size of the traditional agricultural sector, level of consumption of animal protein per capita, enrolment for education - to be used singly or in combination with other indicators.(10) Much of the discussion relating to LDCs is, however, conducted as if there was a homogeneous group of countries identifiable as LDCs. No attempt will be made here to continue the debate on the appropriate yardstick for measurement of development: instead, the classification of developed and less developed countries used by the United Nations agencies(189) will be adopted. SL, the country studied here in depth, falls under the category of LDCs in the UN classification.

With a subject area as wide as the impact of taxation, a researcher is required, at the outset of the investigation, to make a number of decisions relating to methodology - in particular, as to the geographical area and the aspects of taxation to be covered and the research technique(s) to be used. This work is largely a single country study, with broad coverage of

all taxes falling on business, the techniques used being the survey method, content analysis and ratio analysis.

The research techniques used have associated with them various merits and shortcomings, and these will be discussed later. But a major problem in relation to taxation is that it is a most 'sensitive' area of business decision making and there is, therefore, the possibility that business managers may not talk freely about taxes and their tax-related decisions. The multi-technique approach adopted here will, it is expected, reduce the possibility of our findings being biased as a result of such reluctance.

Though the bulk of the investigation of LDC business relates to SL, confirmatory surveys, on a smaller scale, have also been carried out in two other LDCs - viz. Malaysia and the Philippines. Furthermore, investigations into views of managers of western Multinational Corporations (MNCs) relating to their interests in the LDCs add another dimension to the analysis.

The immediate objectives of this investigation are twofold: viz.

(a) to gain an understanding of the perceptions of business managers in regard to taxation, including the various incentives for business development offered through the tax system, and

(b) to ascertain the effects of taxation on major business decisions, such as those relating to type of organisation, investment, financing, distribution of profits and pricing.

These two main themes run through the entire study.

Chapter 1 lays the foundation for the study, with a general review of the literature on the effects of taxation and identifies several questions for investigation.

Chapter 2 describes briefly, the socio-economic background of SL, and reviews the tax structure and administration of the country within the context of which the research has been carried out.

Results of a survey of SL business firms are presented in the next two chapters. Chapter 3 reports the perceptions of the firms in regard to taxation and the manner in which such perceptions appear to be influenced by other organisational characteristics. Chapter 4 discusses the impact of taxation on several major business decision areas and the tax-planning practices of SL firms.

A separate survey of SL professional observers, who in the normal course of their professional duties would be in a position to observe the impact of taxation on business activity, was also undertaken, mainly in order to confirm the findings of the survey of business firms. The results of this survey are discussed in Chapter 5.

Some international comparisons based on surveys carried out in Malaysia and the Philippines are reported in Chapter 6.

Chapter 7 discusses the attitudes to LDC taxation of western MNCs who are perhaps the single most important source of foreign private investment funds to the third world. This discussion is based on a survey of a small sample of UK and US multinational firms. The same issue is examined in Chapter 8: but the technique used is content analysis and the data come from annual reports of UK multinational firms with interests in the LDCs.

Chapter 9 examines the channels of communication between taxpayers and fiscal policymakers in SL. Using content analysis supported by interview data this chapter discusses the response of business pressure groups to tax measures proposed in annual budgets over a period of 13 years.

In Chapter 10, the annual accounts of a sample of SL companies are studied using ratio analysis, in order to provide confirmatory evidence on the impact of taxation on business decisions.

Finally, Chapter 11 brings together the main findings reported in other chapters in a general discussion of the questions for investigation identified in Chapter 1.

CHAPTER 1.

REVIEW OF THE LITERATURE

This chapter will set out the background for the research with a brief review of the literature on the objectives and effects of taxation, and conclude by identifying several questions for examination in this work.

Objectives of Taxation

The impact of taxation on an economy can only be judged against the objectives of taxation. The literature of public finance recognises several objectives or functions of taxation, the most important among these being to provide

a) a system of payment for social goods,
b) a means by which income and wealth may be distributed in what is considered to be a fair manner,
c) a tool for the promotion of economic growth, and
d) a means for achieving short-term economic stability. (131, p.6)

It is of course possible that a certain amount of conflict may exist among these different objectives. For instance, it is possible that a government in pursuance of its economic growth objectives may wish to use the tax system to promote the increase of the overall level of savings in households. At the same time, its priorities of social justice may require the transfer of income and wealth from high income households in which the propensity to save is high, to low income households where the propensity to save is relatively low. The ordering of fiscal policy priorities to

resolve such conflict is usually a problem dealt with at the political rather than the administrative level. The result of attempting to reconcile contradictory objectives, however, can often be unnecessary complication of tax legislation. (104, p.85)

The Search for an ideal Tax Structure

Economists continue to search for the ideal tax system; with many writers looking for inspiration in this search to the classic work of Adam Smith (165) and his canons of taxation. Within Smith's ideal tax system, taxes would (a) be charged according to ability to pay, (b) be known with certainty, (c) be conveniently collected and (d) impose a minimum burden on the tax payer.

The 'ability to pay' principle calls for equality of treatment both horizontally and vertically. For Adam Smith, equality lay in taxpayers contributing "in proportion to the revenue they respectively enjoy" (165) but to later writers equality (used synonymously with equity) means equality of sacrifice of utility, where equality of sacrifice may in turn be defined as equal absolute, equal proportional or equal marginal sacrifice. (131,.p.217) The value of utility analysis in guiding fiscal policy is however limited by the difficulties of estimating the shape of utility schedules and the relevance in the real world of non-utility considerations such as political factors, the existence of unofficial (black) markets and tax evasion and the importance of power objectives rather than utility objectives at upper levels of income. (74)

In relation to certainty, there is a call for greater stability in the tax structure and for fiscal policy to be used less as a tool of short-term economic management. The Meade Committee in the U.K. reported that

> "an essential need is to put a stop to this bewildering process of altering each element in the tax structure as soon as the taxpayer gets used to it and arranges his affairs appropriately. Uncertainty and lack of confidence in the stability of present arrangements are serious impediments to the national effort to improve our economic performance." (94)

Neutrality, or the imposition of a minimum burden, is another attribute demanded of the ideal tax system. At its minimum, the burden of a tax should equal the revenue collected from the tax. If however, in addition to reducing the spending power of the taxpayer (individual or corporate) by the amount of the tax revenue transferred to the government, the tax also distorts economic decisions of the tax payer, there is said to be an 'excess burden' or efficiency cost attached to that tax. An excess burden will arise when a tax affects relative prices and so leads to the substitution of one form of consumption or activity for another. (99, p.21) In the case of business firms, a neutral tax is one which will not cause the firms to allocate resources in any way different from that which they would have adopted in the absence of the tax or not cause them to make any other decisions they would otherwise not have made.

Though it is unlikely that any tax can ever be truly neutral, [152] the view is held by some writers that at a given level of tax revenue it is possible to minimise the distortion of the market by the fisc and to increase the freedom of choice among taxpayers by use of an appropriate mix of taxes. [22] Relative neutrality is one of the main arguments in favour of the substitution of personal income tax by an expenditure tax[103], and corporate income tax by a cash-flow tax. [146]

Taken to their logical extremes, these criteria for the so-called ideal tax structure necessitate the abandonment of all but the pure revenue objectives of fiscal policy. Therefore it is unlikely that they will influence, to any great extent, the fiscal policy of today's governments. This would be particularly true of LDCs where the trend appears to be towards increasing, rather than decreasing government interference in private sector economic activity. [11]

Perceptions of Taxation

A possibility that is not always considered in discussions of the burden of taxation is that the perceived burden of a new tax or a change in an existing tax is influenced by the previous tax experience of the persons concerned. For instance when income taxes were first introduced in the United States in 1913 at rates ranging from 1%-7%, academic opinion at the time was that these rates were "clearly excessive".[70] By contrast, the limitation in 1976 of income tax on earned income in that country to 50% has been praised as averting problems "posed by very high rates".[131,p.474

Dalton rightly draws a distinction between the subjective and objective burden of taxation and argues that

"corresponding to a given objective burden, taxes which are 'much felt' impose a heavier and taxes which are 'little felt' a lighter subjective burden". (38)

Work carried out in developed countries has shown that perceptions of taxpayers regarding the burden of taxation can influence the level of tax compliance.

A field experiment in the U.S. by Schwartz and Orleans (159) showed that tax compliance could be influenced by changes in taxpayer perceptions brought about as a result of suggestions made by the researchers during interviews with individual taxpayers. Survey findings of Strümpel (176) in Europe indicate that the 'tax mentality' of those subject to tax can influence tax compliance. Similarly, in the U.S., it has been found (167) that the likelihood of tax evasion by a taxpayer is positively related to perceived inequities in taxpayer-government exchange.

These results raise the question - what causes differences in perception within a taxpayer population subject to the same taxes? The perceptions of taxpayers in the Schwartz and Orleans experiment were engineered by the researchers themselves. In the other two, no attempt was made to establish causes underlying taxpayer perceptions.

Whatever the objectives of fiscal policy, and whatever the priorities and conflicts among different objectives, in order that effective fiscal policy decisions be made, it is necessary for the decision makers to

understand taxpayer perceptions of the impact of fiscal measures. The investigation of such perceptions in a LDC context, is one of the main aims of this study.

Effect of taxation on Investment

The decision by corporate management to commit resources (usually financial) to the acquisition of capital assets - the investment decision - has been the subject of a wide array of models. These differ inter alia in the manner in which they treat taxation. Jorgenson [102] classifies these various models into three broad groups on the basis of the relevant determinants of investment which are:

"1. Capacity utilization, represented by the ratio of output to capacity, difference between output and capacity, change in output, sales less previous peak of sales and so on;

2. internal finance, represented by the flow of internal funds, the stock of liquid assets, debt capacity, and accrued tax liability;

3. external finance, represented by interest rates, rates of return, stock prices, the market value of the firm."

In the first type of model, investment is described as a function of both the existing stock of capital and the required stock of capital; and taxation does not enter the equation directly. Nevertheless, the required stock of capital is determined by capacity and market considerations, and

taxation will exert an influence on the level of investment via its effect on market demand and supply.

The availability of internal finance would of course be directly reduced by tax payments. However, a point that does not appear to be taken into account in many discussions of the impact of taxation is that in most countries there is a significant lag in time between the enuring of a tax liability and its payment. One empirical study that does recognise the demand made on the stock of liquid funds by tax accruals is that of Anderson [4], which includes the accrued tax liability as one of the independent variables in a regression model of investment behaviour.

Where investment is expressed as a function of rate of return, the impact of taxation is felt as a reduction in expected rate of return leading to a lower level of investment. Musgrave and Musgrave postulate that in a full employment economy,

> "the levels of investment and savings are determined by the intersection of the investment and saving schedules, with investment determined as a function of the rate of interest and savings dependent on both income and the rate of interest." (131, p.493)

In this model, the impositions of an income tax or an increase in the existing rate would result in a downward movement of the investment schedule and a lower level of investment at equilibrium. This is of course a generalised model for an income tax on all sectors of the economy. If the rate of corporation tax increases without a parallel increase in

income tax in the unincorporated sector, savings will move from the high-tax corporate sector to the low-tax unincorporated sector, and in the long term, a new equilibrium for division of savings between sectors will be found. (81) Harberger has calculated efficiency costs of the corporation tax in the U.S. on a two sector model: according to his estimates, the gross national product of the U.S. would have been about one percent higher in the absence of corporation-tax-induced distortions.(82)

As the various determinants of the level of investment specified by different writers are not mutually exclusive, it is not unreasonable to assume that taxation could affect investment both directly and indirectly through its impact on rates of return, on liquidity or through changes in market demand schedules. Whichever model of investment determination is appropriate for a given economy or sector at any given time, an increase in the tax burden on any sector is expected to lead, typically, to a decline in investment in that sector.

The analyses of Harberger and others have however been challenged by Stiglitz (174) who argues that they are in error in using the average cost of capital rather than the marginal cost of capital, when it is the latter which is relevant for investment decision purposes. According to Stiglitz, in the absence of the possibility of bankruptcy, and with full deductability of interest costs, the optimal investment decision for a firm remains unaffected by the tax structure. His analysis is based on the assumption that tax considerations do not affect the decision as to whether the firm should be incorporated or not.

Empirical evidence on the question is however inconclusive. Applying U.S. data to an econometric model of investment behaviour in which investment is described as a function of the existing level of capital and the desired level of capital, Hall and Jorgenson make the following claim:

> "Tax policy can be highly effective in changing the level and timing of investment expenditures. Qualitatively speaking, a change in tax policy that reduces the rental price of capital services will increase the desired level of capital stock. This increase will generate net investment that eventually brings actual capital up to the new desired level ... Even if all the determinants of desired capital remain stationary at their new levels, gross investment is permanently increased by the higher levels of replacement associated with higher levels of capital". (77)

Similar results were obtained for the U.K. by Feldstein and Flemming.(62) Eisner (53), however, testing directly for tax effects using a revised version of the Hall and Jorgenson model (77) found that changes in tax policy had very little influence on the level of investment in the U.S. Bischoff (17) also applying a similar model to U.S. data but using different assumptions regarding underlying economic conditions found smaller effects and a slower response to tax changes than suggested by the results of Hall and Jorgenson. (77) According to Bischoff (17) the lag in response of investment to tax incentives provides proof of the

'putty-clay' hypothesis that changes in relative prices (including those caused by tax incentives) affect spending on equipment with a much longer lag than do changes of output. This is so because the alteration in technology triggered by relative price differences is only possible at a very early stage in the investment process.

In a survey of the post-war development of 36 U.K. firms Mackintosh comes to the conclusion that:

> "If the tax burden were lower,
>
> (i) the rate of development of many firms - probably the majority - would not be affected appreciably, and
>
> (ii) total investment expenditure would rise by a comparatively small fraction of the amount by which the tax burden was reduced". (120)

Though empirical evidence is largely supportive of theory as to the direction of tax effects on investment there is no agreement on the magnitude of the influence.

Incidence and Shifting of Taxation

The discussion thus far has given no consideration to the concept that the effective incidence of taxation need not necessarily match its statutory incidence. The term incidence is used fairly loosely in the literature to describe the direct and/or indirect effects and short term and/or long term impact of taxes on factor suppliers or households. (149)

If the incidence of taxation on business profits is defined as the

effect of the tax on suppliers of capital, then the effective incidence may differ from statutory incidence due to the shifting of the tax either backward to suppliers of other factors of production in the form of reduced prices or forward to customers in the form of increased prices. A business may of course effectively shift taxes without changing prices - for example, by the reduction in quality of goods supplied. The ability of a firm to shift taxes will be determined by a number of factors, the most important of which are the structure of the market in which it operates, price elasticity of its products, the cost conditions it faces and the type of tax concerned.

The essence of the neoclassical theory of shifting has been summarised by Krzyzaniak as follows:

> "In a world of perfect markets or pure monopolies and firms dedicated to short-run profit maximization, investors have no choice but to pay the (corporation) tax out of already maximised profits". (113)

But it is acknowledged that

> "in the short run ... non-profit-maximising behaviour combined with the control over price possessed by firms in imperfect markets, makes tax shifting easier than it would be in a perfect market." (86)

In the long term, the incidence of taxation can become blurred and be difficult to observe because of the effects of changes in other variables

related to market, products, technology, etc. However in theory, the prediction is that in the long-run even perfect-market firms will be able to shift taxes. (113)

There appears to be a generally accepted belief that shifting behaviour for direct taxes is different from that for indirect taxes. According to Herber,

> "Generally, the more direct the tax, the more difficult shifting becomes and the more indirect the tax, the greater the possibility of transferring its burden from the point of impact to another point of incidence. This is explained by the fact that ... direct tax bases in most instances are further removed from subsequent market transactions after the taxes are imposed than are the bases of indirect taxes." (86)

Musgrave and Musgrave state:

> "As distinct from taxes on net income, (sales taxes) must enter into the determination of price and output ... When imposing a manufacturers' tax on automobiles (the legislators) do not intend the burden to fall on the manufacturer. If they wished it to do so, they would impose a tax on the manufacturers' profits." (131)

The implication is that business firms are more likely to shift indirect taxes because they treat these as costs and also that they are

expected by government to do so. The reasons given for 'non-shifting' of a direct income tax imply that, in the short-run, business firms are unwilling to or unable to display profit-maximising behaviour in response to an increase in income tax, largely on account of an absence of a direct relationship between sales and income taxes.

Empirical evidence on the question of tax shifting is inconclusive. Krzyzaniak and Musgrave [112], applying regression analysis to U.S. data have estimated that the degree of shifting of the corporation income tax in the short-run exceeds 100%. Their analysis has however been criticized on the grounds of its lack of theoretical rationale, implausible results and their failure to incorporate all relevant factors into their model.[71][16

Cragg, Harberger and Mieszkowski[37] argue that the Krzyzaniak-Musgrave conclusions are based on a spurious correlation between company profits and corporation tax during the period studied. Using the same data but introducing into the model additional variables representing relative prosperity or depression in the economy and the unusual conditions during war years, Cragg et. al., estimate that 100% of the tax increases are borne by suppliers of capital.

Davis applying the Krzyzaniak-Musgrave model and other variations to the U.K. economy found:

> "None of the main results are consistent with 100 per cent short-run shifting of company taxation. Thus even for the K-M model, which when applied to U.K. data gave the largest estimate of short-run shifting, the instrumental variable

> results generally suggest that less than half the tax was shifted". [40]

Taxpayer behaviour and perceptions on this issue will be examined later in this work.

Taxation and Risk-taking

It must be recognised that the effects of taxation may be felt not only on the amount of investment but also on its quality or on the level of risk inherent in investments undertaken. In an early paper, Domar and Musgrave [45] postulated that given full and immediate offset of losses, a proportional income tax (such as the corporate income tax) will increase the overall level of risk-taking in the economy. They state:

> "If losses can be offset,... the Treasury assumes part of the risk, as well as the yield ... The investor's income, however, has been reduced and to restore it, he will take more risk..."[45]

Feldstein [60], however, argues that the impact of tax on risk-taking depends on the shape of investors' utility functions and that no completely general theoretical assertion is possible.

Stiglitz [172] has shown that, when absolute risk aversion is constant or increasing; or when absolute risk aversion is decreasing but relative risk aversion is increasing or constant, an increased income tax with full loss offset will lead to an increased demand for risky assets.

Academic argument and the quest for a model that best describes the

impact of tax on risk taking still continue, [83][147] but no universally accepted model is yet to be found in the literature.

One point that must be emphasised is that the proposition of increased risk-taking is based primarily on the premise that immediate and full offset of losses will be available under the tax system. This means that this proposition is more likely to apply to established business or investors with adequate profits from other sources against which to set off possible losses from the investment under consideration. In an LDC, where the government seeks to activate enterprise among a largely non-entrepreneurial population, taxation is, therefore, a policy tool of limited value, whatever the intrinsic shape of investor utility schedules. This is particularly true when the likelihood of tax evasion to maintain income at pre-tax level is high.

Tax Incentives

Incentives for increased investment are offered in most tax systems today, and form a major source of variation of the effective tax burden on business from the statutory rate. Opinion in the literature is divided on the question of the usefulness of tax incentives in general as well as on the effectiveness of different forms of tax incentives.

The effectiveness of an incentive can be judged only with reference to the objectives of government in offering it. Generally, the function of an investment incentive is expected to be

a) to promote capital investment levels overall, and/or

b) to bring about a desired balance of investment in the economy.

However, the appraisal of the effectiveness of an incentive can be complicated by the fact that promotion of investment is not the sole or even the main purpose of a tax system and that governments need to balance growth objectives against the primary revenue objectives of taxation. The task is made more difficult by .

a) the failure of legislators and administrators clearly to define the objectives of investment incentives as well as those of tax policy in general, (15)

b) the tendency for different investment incentives to be offered through the tax system and to overlap with one another as well as with other non-tax measures adopted by government toward the same end, (160) and

c) the lack of data regarding costs in revenue foregone and benefits of investment induced by specific tax incentives. (84)

Broadly speaking, tax incentives can be classified as those proportional to profitability such as tax holidays and concessionary tax rates; and those related to some other factor, usually the capital invested, such as accelerated depreciation. (160) The impact of tax incentives on investment is expected to be felt in the opposite direction to that of taxation itself, and via similar routes: viz. through changes in investment returns, changes in liquidity and the availability of

internal funds, and through changes in market prices. The impact on investment returns of incentives is usually measured in terms of increased net present value (NPV).

> "When considering an investment, the investor weighs the present value of its net income stream against the cost of the asset. This present value equals the present value of the income streams before tax minus the present value of tax payments thereon. The latter in turn may be viewed as equal to the present value of the gross tax minus the present value of tax savings due to depreciation."(131,p.497)

Accelerated depreciation allowances enable a firm to postpone tax payments and therefore to increase the present value of investment returns. In periods of inflation, the faster write-off of depreciation would result also in an enhancement of present value in real terms. (130) The liquidity consequences are no less important: under the most generous form of accelerated depreciation allowances, that of free depreciation, the tax postponement resulting from the acceleration of depreciation is equivalent to an interest free instalment loan from the Treasury to the business firm. (69)

It can be shown that the change in present value and, therefore, the benefit of accelerated depreciation depend on

a) the level of acceleration,

b) the rate of tax,

c) the cost of capital at which future cash flows are discounted, and

d) the length of useful life of investment. [18]

The level of acceleration has to be measured by comparing the allowed depreciation with 'true economic depreciation'. True economic depreciation would be neutral as to resource allocation in a tax system which permitted the deduction of interest on capital. [21]

> "If the depreciation rate allowed for tax purposes is set too low, elements of cost are unwittingly included in the base of the so-called profit tax, and the scale of activities affected will in the long-run be contracted. If the opposite mistake occurs these activities will be subsidised." [178]

In offering accelerated depreciation allowances, the objective is indeed to subsidise. But in order to evaluate the subsidy on a particular class of asset it is necessary to calculate true economic depreciation on that class of asset. No satisfactory method is known, however, for estimating patterns of physical deterioration of capital assets. The traditional assumption [101] of a constant rate of physical depreciation has been challenged on both theoretical [135] and empirical grounds. [64] In the presence of inflation, the issue is further complicated by the need to calculate depreciation at current values. [155][177] The current state of the art does not permit the accurate ex ante measurement of the subsidy built into an accelerated depreciation scheme. However, it can be said that free depreciation or a 100% initial

allowance will be neutral as to resource allocation if the profit tax base is defined to include all returns to capital. (175)

The higher the rate of tax, the greater the benefit, in present value terms, of accelerated depreciation. This type of incentive is most effective under a high-tax regime. It is therefore possible, in the presence of accelerated depreciation allowances, for an increase in the tax rate to provide a stimulus for increased investment spending. (77)

Similarly, the higher the relevant discount rate, the higher the benefit of tax postponement obtained from accelerated depreciation. If the discount rate reflects the level of risk attached to the investment, the change in NPV resulting from accelerated depreciation would be greater for risky investments. It has been suggested by Brown (25) that depreciation allowances are more certain than pre-tax income and should therefore be discounted at a risk-free rate. The relative certainty of depreciation allowances referred to by Brown arises from the ability of a firm to set off allowances from one investment against taxable profits from other investments. But the solution offered by Brown of discounting tax savings from depreciation at a risk-free interest rate will no more ensure optimum resource allocation than would the use of a single rate of discount. The dependence of tax benefits in one project on the tax status of other projects presents financial management with the additional problem of evaluating benefits and costs flowing between different projects, across time. The difficulties of capital investment appraisal in the presence of project interdependencies

caused by accelerated depreciation and loss off-set provisions of tax legislation are recognised in the literature, (151) but no satisfactory solution has yet been found. (75)

Generally speaking, the longer the life of an asset, the greater the present value of benefits from acceleration of depreciation allowances. With appropriate cost of capital deductions however it should be possible to design accelerated depreciation schedules that are neutral as to asset life. (21)

The determinants of the impact of a tax holiday upon investment present values are (a) the tax rate, (b) the discount rate and (c) the exemption period relative to the life of the investment or length of the planning horizon, whichever is shorter. The higher the discount rate and the higher the tax rate, the greater the impact on present value of a tax holiday. As for the period of tax holiday, if this is less than or equal to the life of the investment, the longer the holiday period the greater the effect on present value. The extension of the holiday period beyond the life of the investment horizon has no effect on present value as perceived by taxpayers. (181)

The above discussion, like much analysis in the economics of tax effects and tax neutrality, proceeds on the assumptions that investors display economically rational maximising behaviour and that evasion is zero on minimal. In the present analysis, rationality is equated to the maximisation of net present values. However, empirical data show that

even in developed western countries, investment decisions are not always made on net present value criteria. (109) Internal rate of return (IRR), accounting rate of return and payback period are all commonly used criteria. There is every possibility that the impact of tax incentives predicted by theoretical deduction may not prevail in practice, where real-life investor decision-making behaviour diverges from that envisaged in theoretical analysis. For any given firm, the method of investment appraisal adopted by it could influence its perception of tax influences and therefore its response to tax incentives.

It is well known that even different discounted cash flow methods of investment appraisal will not necessarily result in the same ranking of investment projects. (12) Under conditions of capital rationing this could lead to different mixes of investment being accepted under the two main methods of discounted cash flow appraisal - NPV and IRR. It has been pointed out (158) that the post-tax IRR on an asset entitled to 100% depreciation at the time of acquisition will be equal to the pre-tax IRR, whatever the rate of tax. A similar result will however not be obtained from NPV analysis, except for a marginal project where NPV = 0.

The impact of taxation on investment outcomes, under the payback criterion is difficult to predict. This method will give full weight to incentives received within the payback period, but will ignore altogether any benefits accruing after payback on investment has been received. Within the payback period itself, this criterion will not

recognise timing differences. For instance for an investment project with a three year payback period, depreciation allowances of 33·3% of cost over three years will carry the same value as a 100% allowance in the first year.

The impact of an investment incentive perceived under the Accounting Rate of Return decision rules would be different still, and will be influenced by the accounting rules that are used in the preparation of Balance Sheets and Accounts. Under current standard accounting practice in the U.K., (96) a tax benefit arising out of accelerated depreciation allowances would be treated as a timing difference, and provision would be made for tax payments deferred by such allowances, in computing net income to shareholders unless the deferral is considered to be more or less permanent, on account of recurring accelerated depreciation allowances. By contrast, the benefit of a tax holiday would be reflected in the profit and loss account immediately in the form of reduced tax provision. Accounting practice current in the U.S. would yield similar results. According to Hicks:

> "Tax incentives in those forms treated as permanent differences affect accounting income concurrently with cash flows. Those incentives in forms treated as timing differences will affect cash flows differently (typically earlier) than accounting income. For a specified level of tax incentive, whose present value is equivalent regardless of form, the absolute amount of tax benefit and the effect

> on accounting income will be greater with those forms considered to be permanent differences than with those considered to be timing differences." [87]

Though accounting charges will hardly ever be concurrent with cash flows as envisaged by Hicks, the fact remains that Accounting Rate of Return calculations will not be indifferent to type of tax incentive. Moreover it is possible that even where the decision rules actually used for investment appraisal are not related to the Accounting Rate of Return, accounting profit will nevertheless be a constraint on investment planning.[51] If this is so, the response of business to tax incentives may be influenced by current accounting practice in the country.

Empirical evidence on the effectiveness of tax incentives is ambiguous. For the U.S., Hall and Jorgenson have reported on the basis of regression analysis of aggregate data that investment incentives have been highly effective in that country, and that

> "the liberalization of depreciation rules in 1954 resulted in a substantial shift from equipment to structures. On the other hand, the investment tax credit and depreciation guidelines of 1962 caused a shift towards equipment." [77]

Eisner and Lawler [54] however conclude from survey data that though the response to tax incentives is in the direction predicted by Hall and Jorgenson, [77] the shift in investment following tax incentives was much less than that computed by them.

Moving to an LDC, Bird [15] reports that:

> "Interview evidence indicates inadequate depreciation is not felt as a great problem in Colombia, but inadequate liquidity is."

Heller and Kauffman [84] reviewing early results of tax incentives in three countries (namely, Mexico, Puerto Rico and the Philippines) report that

1) in all three countries, the increase in investment, output and employment that can be attributed to the tax-exempt companies is not substantial,

2) in the Philippines, according to their Central Bank, a high proportion of new exempt investment went into nonessential consumer goods, and

3) in all three countries, most tax exempt companies have earned extremely high profits, suggesting that investment would have taken place even without exemption, and further that these high profit companies are not in any way high risk companies.

In a more recent article, Shah and Toye review a number of surveys and econometric studies of the impact of incentives in both developed and less developed countries and conclude that

> "The most that can be said is that their impact is either slight or unknown."[160]

Many explanations have been suggested for the low effectiveness of tax incentives in LDCs.[84] Briefly, the more important of these are

1. Tax incentives may not be material if the tax rates are low as the benefits of incentives will also then be low.
2. Tax incentives will be of little use when the factors limiting growth are unrelated to taxation. In LDCs, these are most likely to be the low level of development itself and the inadequacy of market demand and government restrictions of one sort or another.
3. Tax incentives are less effective when tax-evasion is widespread.

LDC governments may nevertheless feel compelled to give incentives to foreign investors to keep up with other neighbouring countries in similar conditions. Shah and Toye [160] associate this tendency with small island or quasi-island states which seek to promote export oriented foreign investment.

Taxation and Financing of Business

Taxation can have an impact not only on the investment decisions of a firm, but also on its choice of a mix of finance. To simplify the analysis let us assume that a firm has access to two types of capital - debt and equity. The corporation income tax typically allows the deduction

of interest on debt capital in computing income whereas returns to equity are the after-tax profits.

The impact of taxation enters the optimal capital structure controversy in the form of a market imperfection. The question at issue in the controversy is whether or not the market value of a firm is influenced by the financing mix of its capital. The separate question of the cost of capital will not be considered here.

The theoretical extremes in the range of possible bases of valuation of the firm have been identified by Durand [49] as the 'Net Income' and 'Net Operating Income' approaches. The net income method capitalises income after meeting interest charges to arrive at the value of equity capital: the value of the firm would then be the sum of the values of debt and equity. The alternative net operating income method capitalises operating income before interest deduction to arrive at the value of the firm inclusive of the value of debt.

If the capitalisation rate were the same for each method, under the net income method the value of the firm would increase with increasing debt in the capital mix. In contrast, on the net operating income approach the value of the firm would be invariant with respect to changes in the finance mix. Durand was of the opinion that neither method, strictly interpreted, would give an adequate model for the valuation of a firm.

Later Modigliani and Miller [128] in a controversial article produced theoretical argument and empirical evidence to support the net operating income method of valuation. They hypothesised that at equilibrium the

market value of a firm is independent of its capital structure such that

$$V_j = (S_j + D_j) = \frac{\overline{X}_j}{p_k} \text{ for any firm } j \text{ in class } k$$

where,

V = value of the firm

S = market value of the equity

D = market value of debt

$\overline{X}$ = expected returns before interest on assets owned by the firm, and

p = the capitalisation rate appropriate for the class.

They adjusted the above formulation to reflect the tax-deductability of interest payments and argued that, in the presence of taxation, the value of the firm becomes

$$V_j = \frac{\overline{X}_j^t}{p_k^t} \text{ for any firm } j \text{ in class } k ,$$

with $\overline{X}_j^t \equiv (\overline{X}_j - rD_j)(1 - t) + rD_j \equiv \Pi_j^t + rD_j$

where, $\overline{X}_j^t$ = expected income of the firm after tax but before interest

r = rate of interest on Debt

t = rate of corporation tax

Π_j^t = expected profit to equity after tax

p^t = the capitalisation rate of the appropriate risk class.

Hence, even in the presence of taxation, the value of the firm would be independent of financial leverage.

Their proposition and the empirical results have been the subject of criticism from many quarters (50)(173) on a number of grounds - mainly that their treatment of tax is incorrect and that they ignore or dismiss too many other market imperfections such as bankruptcy costs and the non-substitutability of personal borrowing for corporate debt.

Modigliani and Miller correct the 'error' in the treatment of taxation in a subsequent paper (129) to arrive at the value of the firm,

$$V_j = \frac{\bar{X}_j^t - tR_j}{p^t} + tD_j = \frac{\bar{X}^t}{p^t} + t\frac{(p^t - r)}{p^t} D_j$$

where,

R = the interest bill.

It can be seen that now, the value of the firm is influenced by leverage, and would increase with increasing debt provided $p^t > r$. If this proposition were true, the optimum capital structure for a company could be 99.9% debt. That this is obviously not true of corporate financial structures was accepted by Modigliani and Miller, who suggested the following as possible reasons,

> "... other forms of financing notably retained earnings, may in some circumstances be cheaper still, where the tax status of investors under the personal income tax is taken into account. More important, there are ...

limitations imposed by lenders, as well as many other dimensions (and kinds of cost) in real-world problems of financial strategy which are not fully compensated within the frame-work of static equilibrium models, either our own or those of the traditional variety." [129]

Central to the analysis of Modigliani and Miller was the assumption of risk classes; but it has since been shown by Hamada [78] that the presence of risk classes is not necessary to support their view of valuation of the firm which can be equally feasible within a capital-asset-pricing model valuation.

In a more recent paper, Miller [126] argues

a) that tax advantages of debt financing are reduced in the presence of low effective personal taxes on equity earnings arising from low rates charged on capital gains and their taxation only at time of realisation, and

b) that though there will be a market equilibrium level of gearing in aggregate, that there will be no optimum gearing for any individual company, and that each firm will attract a clientele of stock holders whose preferences match its financing and dividend policies.

Miller's view of a market-wide equilibrium obtained without optima at the level of individual firms has however been challenged by Litzenberger

and Van Horne [118] who argue that it is internally inconsistent.

Brennan and Schwartz [23] suggest that uncertainties relating to expectations of future tax benefits of debt financing (which will be received only if there are sufficient profits to offset interest payments) and the increased likelihood of bankruptcy costs would combine to counter the tax benefits of gearing so that there will be an optimum gearing level for any firm.

Empirical evidence has been presented by Miller and Modigliani [128] in support of their proposition. Both their methods and their results have however been questioned by Weston [192] who argues that the lack of correlation between the cost of capital and leverage observed by them is due to counter-balancing influence of earnings growth on leverage. Hamada [79] on the other hand offers support for the M-M proposition on the basis of his findings of greater mean values for observed betas of levered U.S. firms in comparison with calculated values of beta for hypothetical cases.

In further support of their proposition that tax effects are unimportant, Miller states that

> "the debt/asset ratio of the typical non-financial corporation in the 1950s was little different from that of the 1920s despite the fact that tax rates had quintupled." [126]

Empirical evidence on the low relevance of tax considerations in

financing decisions has been presented by Coates and Woolley, [33] who in a comparative study of tax rates and gearing levels in several European countries conclude that there is no clear relationship between the rate of corporation tax and the level of gearing.

It is however generally acknowledged that there is a need for both further development of theory and empirical testing in this area. [30]

Taxation and Distribution of Business Profits

Academic argument relating to the distribution of profit centres mainly on two questions: firstly as to whether dividend decisions are actively made by companies or whether dividends are residual funds after meeting requirements for reinvestment, and secondly, as to whether the value of a firm and its share prices are affected by the proportion of earnings distributed.

Miller and Modigliani have argued that

> "... the irrelevance of dividend policy given investment policy is obvious, once you think of it ... In a rational and perfect economic environment ... values ... are determined solely by 'real' considerations - in this case the earning power of the firm's assets and its investment policy - and not by how the fruits of the earning power are packaged for distribution." [127]

They further postulate that any shareholders in need of current income

can always sell part of their holdings and so substitute home-made dividends for corporate dividends or that a company will attract a clientele of shareholders whose dividend expectations match its payout policies.

The Miller-Modigliani proposition has been criticised on the grounds that market imperfections make it unlikely that it will hold in the real world. Taxation is perhaps the most important market imperfection impacting on the dividend decision. (63) Tax systems in most countries assess distributed corporate profits differently from undistributed profits. (80) Where a company is charged income tax on its profits and shareholders are again charged on dividends received, the effect is that distributed profits are doubly taxed while retained profits are charged only under the corporate profit tax. To the extent that such retained profits are reflected in share prices, capital gains will arise. If capital gains are taxable, these will usually be chargeable at the time of sale of shares, which may of course be at a much later date, and often at concessionary rates. There have been calls for integration of personal and corporate tax structures to eliminate double taxation and resultant distortions in the market process of resource allocation (122) and many European countries have moved in this direction in recent years. (140)

Under the so-called 'classical' taxation system (where corporate profits are taxed both in the hands of the company and in the hands of its shareholders) and under other systems of partial integration, a high retention policy is favoured. However, other market imperfections may provide counter-influences in favour of dividend distributions. For

instance, Gordon [73] contends that the uncertainty attaching to dividend distributions increases with the distance in time when future dividends are to be received, with the result that the value of future dividend expectations resulting from retentions have to be discounted for greater uncertainty. Van Horne [190, p.334] points out that transaction costs and the non-divisibility of securities will deter the sale of shares to substitute for dividends by share owners in need of current income. There is also the view that there is an informational value attached to dividends in the market pricing of shares. [145]

As with other major issues relating to the impact of taxation, empirical evidence on this question is ambiguous.

Fama, [59] testing a number of dividend and investment models on U.S. firms, concludes that dividend and investment decisions are independent as implied by the Miller-Modigliani analysis. Bar-Yosef and Kolodny [9] produce empirical evidence in support of the view that dividend policy can influence share prices. Black and Scholes [19] on the other hand find evidence to the contrary.

Again, Elton and Gruber [55] find that the implied tax bracket of marginal investors varies inversely with the payout ratio, implying a clientele effect with reference to investor tax brackets. Feldstein [61] and King [108] also report evidence of tax system affecting payout ratio, though their estimates of level of influence differ. Briston and Tomkins [24] however report that the introduction of corporation tax in the U.K. which was intended to induce higher overall retentions did not achieve this objective.

Taxation in LDCs

The discussion so far has dealt mainly with taxation in the context of developed countries. A substantial body of literature also exists relating to taxation in LDCs; the writings usually taking the form of descriptions of tax structures and recommendations for reform.[13][48][106] The major differences between tax systems of developed countries and LDCs covered by this literature can be classified as relating to

a) fiscal objectives
b) tax effort and types of taxes charged
c) tax-payer characteristics and
d) tax administration.

In the LDCs where development objectives receive high priority, fiscal systems are also geared for the promotion of development.

> "In the underdeveloped economies, taxation is increasingly assigned a far more positive role in the process of capital formation and technological change. The reason for this is implicit in the extremely low levels of income and savings which serve as the source of capital formation." [85]

Because private savings are in short supply the governments find it necessary to undertake large investment programmes in the public sector. Consequently there is a need for a high level of government revenue to finance development programmes. Furthermore in LDCs with a democratic form of government, the redistribution of income and wealth has, in recent

years, become an important objective, [188] advocated in the interests of national political stability. [28] At the same time, for many LDC governments

> "a major consideration is to prevent the tax system from becoming too much of a disincentive on effort, initiative or enterprise. Taxes on income make it less attractive to undertake work or to risk capital in productive enterprise." [104, p.10]

As pointed out by Professor Heller.

> "One way out of the dilemma [is] to combine high rates of taxation in general with preferential treatment for categories of desired development activity." [85]

Most mixed-economy LDCs have, in fact, done just this, and many incentives to the private sector have been offered through the tax system. [97] The bulk of such tax incentives have gone to manufacturing industry.

> "Although it is possible to attain a high level of income by concentration upon the development of efficient agriculture, as is evident from the experience of New Zealand and Denmark, there is little question that most less developed countries are interested in promoting the manufacturing sector above all others." [84]

However, the result of generous tax incentives combined with other

protectionist measures often designed to encourage import substituting industries are now recognised to have been not wholly desirable. Subsidies offered for capital investment have produced high technology, highly capital intensive industries in these nations where unemployment and underemployment are high and capital is the scarce resource. More recent studies have pointed out the inappropriateness of direct transfer of western technology encouraged by investment incentive schemes; (194) and the greater benefits to be achieved in providing incentives for increased employment (116) and for high utilization of existing industrial capacity. (32)

Another way in which the objectives of the LDC fiscal policy differ from those of developed countries is that short-term economic management, an important objective in developed countries, is less relevant in an LDC context. The economic rationale for the adoption of stabilization objectives requires the assumptions

a) "that some part of the capital stock lies idle because of generalised lack of demand, whereas typically in a poor country unutilised capacity results from some particular supply bottlenecks which persist despite powerful internal demand for those products" and

b) "the origin of macroeconomic fluctuations lies in sagging investment demand following 'loss of confidence' by domestic private investors, whereas typically in a

> poor country macroeconomic fluctuations arise from exogenous influences transmitted by foreign trade from the international economy." (184)

The typical levels and composition of tax revenue in LDCs are also reported to differ from those of developed economies. The tax yield as a ratio of gross national product is generally lower than in developed countries. (29) So also is the tax paying population.

> "In the U.K. some 20 million individuals pay income tax each year and in the U.S.A. some 65 million - i.e. of the order of 30-40% of the total population. In many under-developed countries it is a real achievement to reach a figure of 5%." (148, p.34)

The main differences in the revenue composition are said (148) to be that in the LDCs,

a) Consumption based taxes provide 70-80% of revenue rather than the 40-50% found in developed countries,

b) import and export based taxes play an important role,

c) Corporation taxes are less prominent,
and

d) Capital taxes are not common.

The picture that emerges of LDC tax patterns is one of relatively low taxable capacity and tax levels, with the emphasis on indirect taxes -

particularly customs duties. Underlying the divergence in the tax structures between the two types of countries are differences in the economic background, in taxpayer characteristics and in the competence of tax administration. Prest declares that LDC tax assessment can be extraordinarily difficult

> "when ... weights and measures are far from standardised, when one has either an illiterate peasantry which is incapable of keeping accounts or a semi-illiterate group which is unwilling to do so, and when a large proportion of output is not exchanged in the market for money and to the extent that money transactions do occur, they are in cash rather than credit form." (148, p.37)

LDC tax administrators are believed to be less efficient than their developed country counterparts (16) and their job is said to be made more difficult by the greater propensity among LDC taxpayers to evade taxes. In the view of a U.K. writer, LDC fiscal scenes are characterised by

a) "the inheritance of a complex tax code from the former colonial rulers [which] is usually more than the present administration can cope with" and

b) "a big gap in fiscal morality between expatriate companies trading locally either via branches or via companies locally registered and controlled and the attitudes of local capital." (39)

Given such differences, it is appropriate to question whether the impact of taxation on business and their response is different in LDCs from that predicted by economic theory in the context of a developed country background.

LDC Taxation of International Business

When a business firm becomes a multinational, a whole new dimension is added to the impact of taxation on its activities. On the one hand more than one government will have a 'fiscal interest' in the income of the firm: as most governments tax income on the basis of residence as well as with reference to the location of source of income, the firm may be chargeable to income (and other) taxes in both its 'home' country and the 'host' country. At the same time, the firm has open to it greater opportunities for global tax minimisation in moving goods and funds between countries. (125) The revenue authorities usually insist that transfer prices between branches of a firm or members of a group be fixed on an 'arms length' basis; but the policing of this requirement is difficult, particularly where the transfers are of technology or patents or specialised goods with no known comparable market prices, and when the revenue authorities concerned are short on administrative expertise. (142)

Tax considerations can be important not only in transfer pricing decisions, but also in decisions relating to the locating of production facilities.

> "In deciding whether various taxes do or do not interfere with the location of production, the key question is whether the tax affects the relative prices of home-produced and imported goods. If it does, consumers will substitute one for the other and the location of production will differ from what it would have been under neutral taxes." (44)

Low tax locations may be used with advantage not only as centres for production but also for purely financial purposes. Multinational firms looking to minimise their global tax-bill have available to them the so-called 'tax-havens' - usually small countries in which little or no taxes are charged on all or certain types of business activity. It is possible for a multinational investing abroad to route its investments via a holding company in a suitable tax haven and to collect income, free of home country taxes; or to delay the payment of home country taxes by these means. In post war years a whole host of tax havens have sprung up around the world offering privileges of little or no taxes to foreign business along with freedom from exchange controls, facilities for offshore banking and investment as well as confidentiality as regards transactions undertaken in such locations.

Though tax considerations can, theoretically, influence both locational decisions and intra-group transfer prices of MNCs, increasing anti-avoidance legislation and other government controls such as import and exchange controls limit the scope for tax minimisation.(31) Once again, empirical evidence is inconclusive.

The report on a recent survey of the activities of U.K. multinationals abroad suggests that taxation may not be very important in locational decisions but that tax considerations are relevant in intra-group transactions across national boundaries. (91) Market potential was found to be the most important 'host country factor' affecting location of direct investment abroad by U.K. multinationals.

By contrast, a survey (111) of multinational corporations operating in Singapore has reported that the political and social stability of Singapore was the single most important factor attracting foreign investors to that country and that market potential was relatively unimportant. Singapore is however well known as a low-tax export platform for multinationals and these findings cannot be said by extension to have general applicability to all LDCs.

The Meade Committee in the U.K. (94) suggests that taxation is probably not the prime consideration in locational decisions and that quite marked differences can exist between national tax burdens without these resulting in extensive movement of capital and persons from the high tax to the low tax countries.

Empirical studies (2)(100) in South American developing countries have concluded that tax incentives have had little influence on multinational investment in this area. Multinational investment in developed countries,however, appears to be more sensitive to tax incentives.(66)(171)

The majority of LDCs display mixed attitudes toward MNCs. On the one hand the typical LDC offers tax and other incentives (35)(153) for

incoming foreign investment; but at the same time the MNCs are regarded with fear and suspicion [136] and LDC governments seek to control their activities in various ways. [154]

Many LDCs also have in existence double tax relief agreements with capital-exporting developed countries. The value to a MNC of such agreements however is variable; depending on the relative tax rates and bases of the countries concerned. For instance, multinational firms based in the U.K., which in any case enjoy unilateral relief from double taxation,[1] may not find any particular benefit in a double tax agreement unless it also included favourable tax-sparing provisions.

Fiscal Politics

The discussion so far has been carried out in terms of economic analysis, where all taxpayers make rational economic decisions in response to taxation. Much of the theory referred to has been formulated in the context of a western developed country underpinned by assumptions of perfect or near perfect markets and a rational, profit-maximising business sector. Furthermore, this analysis portrays taxpayers, be they individuals or corporations, largely in a passive role as far as fiscal policy affecting them is concerned; paying their taxes when they become due and attempting to achieve their economic goals within the constraints imposed by taxation.

But is this a complete and fair representation of the real world? The field of political analysis offers a somewhat different view of the

interactions between fiscal policy and business activity. Decision making in democratic nations (including fiscal policy decisions) is seen as the outcome of a political process wherein all participants - voters, politicians and the bureaucracy - attempt to maximise their self interest. (47)(198)

With reference to fiscal policy, it is recognised that any policy adopted via such processes may leave some taxpayers dissatisfied; as whatever the policy, it is unlikely to reflect exactly the preferences of every taxpayer regarding the size of the public sector and the method of payment for it. (131, p.119) It is expected that persons dissatisfied with the policy adopted will form pressure groups to try to influence the legislators and the voters in their favour. (139) Musgrave and Musgrave (131, p.120) discuss fiscal interest groups active in the U.S., but are of opinion that the organisation of consumer and taxpayer groups is more difficult than the organisation of industry or union interest.

Bird and Oldman (16) are of the view that open discussion on tax policy is less common in LDCs and that thisis due mainly to a low level of tax education among the public. Political researchers however report that business pressure groups in general are less well organised in developing areas than in developed countries. (3)

Behavioural Aspects

Another analytical framework useful in the study of interactions between business organisations and government fiscal policy can be found

in the literature of organisational behaviour.

As hypothesised by Thompson,

> "technology and environments are major sources of uncertainty for organisations and ... differences in those dimensions will result in differences in organisations." (183)

If the tax structure is looked upon as an environmental variable* affecting an organisation, then according to Thompson's analysis it may have a bearing upon the way in which business is organised within its geographical sphere of influence. Emery and Trist (56) classify the environment according to the degree of order and the degree of stability and argue that organisational response will vary with the structure of the environment. Hall (76) in an extension of the above analysis argues that organisations which ordinarily operate under norms of rationality may discard these in the face of severe environmental threats. From another point of view

> "The attitudes of organisational members towards change are crucial in the growth process. They are crucial because growth is a type of organisational change and they are crucial because a growing organisation must adjust to environmental change. In fact, it can be argued that growth depends upon the organisation's ability to exploit opportunities created by environmental change." (170)

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* The 'environment' for our purposes is defined to include all factors affecting business operations which are outside the control of managers of a business firm.

Within this framework, the response of business to taxation may be seen as being conditioned by the harshness of the tax system and its variability. A successful business organisation will be one that can adapt quickly to changes in the environment including the tax environment.

Conclusions and Questions

The ideal tax system will provide necessary government revenue in a manner that is fair by all taxpayers, is easy to collect and does not distort rational economic choice in the market. But it is conceded that virtually any tax, except perhaps a poll tax, could have distortionary effects.

Co-existing with the idea of a fair and neutral tax system is the recognition of the uses a tax system can be put to in management of the economy - in pursuance of short term stabilizing goals or longer term development or distribution goals of the State. Effects of taxes have been studied both at the 'macro' or economy level and at the 'micro' or taxpayer level: the impact of any new tax or tax change, it is agreed, depends on the extent and patterns of shifting of the tax.

Our concern here is with micro-level effects. In theory, taxpayers at this level will make rational economic choices among alternative courses of action to maximise their profits or utility functions. In the presence of taxation it is the after-tax profits or utilities that will be maximised. Theoretical reasoning leads us to expect that taxation will influence savings, investment and risk-taking in the private sector,

business financing and dividend policies and the valuation of securities - virtually all the major decisions of business firms and investors. But it is recognised that in LDCs, where types of activity, organisation of business, ethical standards, administrative capabilities and accounting practices are likely to be different, the taxpayer reactions may also be different. Empirical evidence on most issues relating to the effects of taxation is ambiguous in relation to developed economies and sparse in relation to LDCs.

The foregoing survey enables us to delineate several broad questions for study in relation to LDCs: viz.

(a) Are similar perceptions of and attitudes to taxation widely shared among various participants in business activity?

(b) Is the manner in which taxation is incorporated in decisions of business organisations consistent with rational economic decision-making as envisaged in economic theory?

(c) What effects does taxation have on decisions of LDC business firms?

(d) With reference to multinational corporations, are tax conditions and business responses any different between developed countries and LDCs?

(e) What are the implications for taxation policy in the LDCs of the answers to questions (a) - (d) above?

This work reports findings on these questions, mainly with reference to one LDC, in an attempt to contribute to a better understanding of the effects of taxation on business development in the third world.

CHAPTER 2.

SRI LANKA - A case study

Most of the research reported in this work has been carried out with respect to Sri Lanka on data pertaining to the period 1965-1977 or part thereof. It is a prerequisite of such in-depth analysis that the discussion be conducted in the context of the relevant socio-economic conditions of the country concerned. This chapter will

a) introduce the reader to the socio-economic background within which both business and the fiscal system operate in SL, and

b) review the form and administration of taxation in the country.

The Country and its People

Sri Lanka is a small country - an island 65,000 square kilometres in area situated at the southern tip of India. It has a population of around 14 million. During our study period it was a welfare state, with free rice, free education and free health services being offered by the government to its people. Some of the consequences of the welfare schemes were a fast growing population with (for a LDC) long life expectancy, a high population density, a high literacy rate and high and rising unemployment. Some international comparisons of pertinent statistics are provided in Appendix 1.1.

The country has a multiracial and multi-religious society, with

the majority community, the Sinhalese (71% of the population) both holding political power and dominating the administration. Two sizeable minority groups, Tamils (20%) and Moors (7%) who keep their separate identities, play an important role in business, particularly in the wholesale and retail trades. As in most multiracial societies there is an uneasy co-existence between the different ethnic groups. The tensions between the Sinhalese and the Tamils have erupted into major outbreaks of communal violence twice in the past twenty five years. Permeating the social relationships of the two major ethnic groups are also caste differences, with political power being concentrated in the hands of the majority caste of the majority community.

The Government

Sri Lanka gained independence after 150 years of British colonial rule in 1948. Prior to the coming of the British, parts of the country had been colonised in turn by the Portugese and the Dutch. The influence of these western colonisers is still seen in the country - in the form of the small and dwindling (through emigration) population of 'Burgher' descendents of the Portuguese and the Dutch, the presence of British business interests, and the political and administrative systems and commercial practices inherited from Britain.

Since independence in 1948, Sri Lanka has been a lively democracy with a high degree of political awareness among its people,* and two major political parties - the United National Party (UNP) and the Sri Lanka Freedom Party (SLFP) - alternating in government. The country has

* 87% of the electorate voted at the last general election.

had seven general elections since independence and there have been changes of government at all but one of them.

The only major threats to law and order have come from the outbreaks of communal violence in 1958 and in 1977, and the insurrection of 1971 in which the participants were mainly unemployed youth of minority caste groups. Academic observers believe that all these upheavals had economic grievances as part of their root causes.[124][137]

Though, prima facie, Sri Lanka is a model of a successful parliamentary democracy, the very success of the system as seen in regular changes of government, the above-mentioned outbreaks of violence, the presence of highly vocal groups of left-wing political activists and increasing interference by the government in private sector economic activity, have contributed to perceptions of political uncertainty among businessmen and have consequently proved to be a barrier to private investment and a deterrent to the inflow of private foreign capital into the country. [98]

The twin main objectives of all governments since independence have been economic development and the achievement of a more equal distribution of income and wealth in the country. [211] In formulating a policy for the achievement of their objectives these governments have been faced with two main problems, that of balance of payment deficits which plagues most developing nations and that of a high level of unemployment.

The Economy

As a typical third world country, Sri Lanka has the main attributes which characterise an LDC; viz. a low per-capita national income (see Appendix 1.1) and a large proportion of its population (51%) engaged in agricultural activity. Despite continuing government effort, economic growth has not been notably high, mainly due to the ever-worsening international terms of trade.

The economy is tripartite - with a plantation sector, a rural sector and an urban sector. The plantations produce the crops of tea, rubber and coconut, which provide the main source of foreign exchange earnings for the country. The rural sector in which peasant farmers produce some of the country's food requirements suffers from low productivity, with the consequence that many essential food items have to be imported from neighbouring countries. There are some, mainly craft-type, manufacturing industries in the rural sector, but the bulk of the manufacturing and commercial activity takes place in the urban sector.

Since the mid-fifties stagnant prices of the main export crops coupled with increasing world prices of imported food, capital goods, industrial raw materials and petroleum products have resulted in continuing balance of payment problems. These in turn have led to the imposition of import controls and exchange controls of increasing severity over the years.

There has also been in evidence an increasing government role in economic activity, with activities hitherto in private hands being taken over by the public sector. Business nationalisation which began in the

late fifties with the acquisition of private passenger transport firms, has continued during the tenure of successive SLFP governments. Petroleum distribution, insurance, manning of services at the sea ports, the bulk of the import trade - have all been acquired by government agencies over the years. Finally, with the enactment of the Land Reform Law (209) the ownership of all large plantations also passed into the hands of the State. It has been estimated that at the end of the seventies the government controlled 60% of the country's industrial output and 70% of its trade.(169) The existence, in the statute law, of a Business Acquisition Act (202) giving wide powers of nationalisation to the government is widely believed to have been a major disincentive for investment. (119)

Alongside the widespread government controls and despite the nationalisations government has offered many incentives for new investment and increased economic activity in selected spheres of business. In the late fifties and the early sixties, most the incentives offered were for import substituting industries. The emphasis shifted in the late sixties to agriculture and tourism and again in the seventies to the promotion of non-traditional exports. Apart from tax concessions, many other forms of incentives and assistance were offered by the government for encouragement of these preferred activities. The main non-tax incentives have been the following:

a. Foreign Exchange Entitlement Certificates [FEECs] - a dual rate currency exchange system introduced in May 1968, whereby a premium on the official exchange rate was payable to certain exporters,

b. Convertible Rupee Accounts [CRAs] - whereby unrestricted usage of a percentage of foreign exchange earnings was allowed to exporters of non-traditional products; and

c. Cash Subsidies - given mainly to agriculture, for replanting plantations, mechanising tea production, purchase of fertilizers, etc.

Another facet of the economy which must be noted is the importance of foreign aid to the country which has since the late fifties come to rely very much on assistance from the World Bank and other UN agencies as well as from Western aid-giving nations.

The Private Sector

There are several distinct types of business organisations operating in Sri Lanka. Firstly, there are the subsidiaries and associates of MNCs which are mainly British-owned though there are also several American firms operating in the country. Most of these companies have been operating in Sri Lanka since before independence though many of them have set up manufacturing establishments only in more recent times, under the programme of import substitution. A feature of multinational operations in Sri Lanka is that though the subsidiaries in the country are large firms by Sri Lankan standards, they form an insignificant part of the total operations of the MNCs concerned.

> "... Ceylon Tobacco, although the largest company active in Ceylon, accounted for scarcely more than 2% of the

> parent firm's global turnover in 1967; Lever, a giant amongst Ceylon companies, accounted for less than 0.5% of the total sales of Unilever (U.K.) in 1965; in Glaxo, the ratio was less than 1% and so on. (65)

The other type of foreign investors operating in the country, the individual businessmen, have been leaving the country since independence mainly due to government restrictions on their business activities or non-renewal of residence permits.

The government of Sri Lanka has always in principle welcomed foreign private investment to the country particularly in manufacturing industry,(210) though from time to time they have imposed restrictions on outward remittances on the existing investments in order to check the continuing deficits on the Balance of Payments and also sought to control the employment of foreign personnel in the country. An examination of the balance of payments figures from 1957 to 1974 (203) shows however that in this period the outflow of private funds on transfer payments and capital account each year have exceeded the inflows.

Among the large and medium-sized local businesses, there are the professionally managed corporate organisations and owner-managed family businesses. Though a clear dividing line cannot be drawn between these two types of organisation, at one extreme of the range are the publicly quoted limited liability companies managed by indigenous professional managers. At the other end of the range of local business are the individual entrepreneurs - mostly men of little or no education, known as 'Mudalalis', who have started from small beginnings and built up highly

successful businesses and who are in full day to day control of their respective firms. Among the in-between types of organisation are many second or third generation family businesses, often founded by mudalalis, but now owned by divided family interests and to the concerned observer often seemingly lacking in the vitality evident in the days of their founders.

There is a network of commercial banks and one development bank serving the financial needs of the Sri Lankan business community. However, the security market in Colombo (operated by the Colombo Brokers' Assocation) which has never been large or very active, has in the seventies, particularly since the nationalisation of the plantations, been in a more or less stagnant state.

The picture of the Sri Lankan business scene will not be complete without a reference to the massive blackmarket which exists side-by-side with the official economy. In this blackmarket can be bought goods otherwise unavailable because of import controls or goods in short-supply or those subject to price control in the official economy. This 'cash-economy' also extends to illegal trades such as bookmaking, and dealing in foreign currency by persons other than authorised banks, as well as to premia on otherwise lawful transactions which are undervalued in the official declarations.

Changes since 1977

After the end of our study period, sweeping changes have been introduced in a number of areas of government control, by the UNP

government which came into power in July 1977. Import controls have been removed; exchange controls have been greatly relaxed; a part of the country has been designated a 'Free Trade Zone' offering a tax haven to foreign business. These and many other changes are reported to have had widely felt repercussions on the economy,[223] and could mean that some of the problems and constraints on business observed in our research no longer apply in this country.

The Tax Structure

Taxation is not a new concept in Sri Lanka: even under the ancient Sinhala kings there were production taxes and estate duty.[43] A scheme of 'Rajakariya', or service tenure in lieu of taxes, was also operated.[36]

The western colonisers, while retaining most of these taxes added more of their own devising.[36] The Dutch introduced customs and excise duties and the British in their early days experimented with a host of taxes - such as the land tax and the 'joy tax' (on jewellery). Later, in 1932, during the depression, the income tax was introduced, to make up for a fall in revenue from customs duties.[36] The rates of income tax in the thirties were however low: resident individuals paid between 5 and 18%; resident companies were charged 15% and non-resident companies 18%.[207]

The present system of direct taxation, including individual and corporate income taxes, a wealth tax, capital gains tax and a combined scheme of gift tax and estate duty was introduced on the recommendation

of Nicholas Kaldor, [105] in 1957. Since then, however, there have been many changes in the bases and rates of both direct and indirect taxation. It has been reported [180] that between 1953 and 1968, twenty one new taxes were imposed, of which only six remained at the end of 1968.

The tax with the highest revenue potential, to be introduced since 1957, is the Business Turnover Tax (BTT), a multistage cascading tax, first charged in 1964, at rates of ½% and 1% of turnover but standing in 1977 at rates ranging between 1% and 48%. [206] Another tax of far-reaching social consequences was the 'Capital Levy' introduced in 1970,[204] whereby individuals liable to wealth tax were required to pay between 3% and 25% of their wealth as a once and for all lump-sum tax.

Another source of government revenue, which is in the nature of a pseudo-tax is the Sale of Foreign Exchange Entitlement Certificates (FEECs). This is a scheme whereby importers have to 'surrender' FEECs to the government for the right to import non-exempt goods which in fact means that they pay a premium on the official rates of exchange for such imports. This requirement to surrender FEECs is combined with one for the issue of FEECs to exporters of specified goods which give the exporters more rupees for their exports than their entitlement at the official rates of exchange. In effect, the FEEC scheme is a dual exchange rate system covering most imports and all exports excluding the major 'traditional' exports of tea, rubber and coconut.

During the study period, the maximum rate of individual income tax has varied between 50% and 80% and the standard rate of corporation income

tax between 50% and 60%. [208] Corporate dividends are liable to a $33\frac{1}{3}$% withholding tax. Dividends are charged to income tax in the hands of the shareholder (unless the shareholder is a resident company) who is entitled to a tax credit on the $33\frac{1}{3}$% withholding tax. Capital gains arising after 1st April 1956 are taxable on realisation, but at a concessionary rate. Dividends received by one resident company from another are not subject to corporation income tax in the hands of the recipient company. Other taxes charged in this period have included an expenditure tax imposed twice and removed both times within a couple of years, a bank debit tax also twice imposed and removed, a land tax, a share capital tax, and various surcharges on income tax.

The main group of taxes charged over the period and their contribution to government revenue can be seen in Appendix 1.2.

It can be seen in Appendix 1.3 that total government revenue as a percentage of GNP has averaged at about 20% in the years 1968-1977. This is somewhat higher than the average for developing countries calculated by Prest [148, p.13] but well below his average for developed countries.

The proportion of tax revenue in total government revenue has remained at a fairly steady level at around 80% throughout the above period (see Appendix 1.3). The proportion of revenue contributed by the major classes of taxes have also remained more or less the same over the period. Production and expenditure based taxes provide the majority of tax revenue, but within this category, a change in tax emphasis can be observed, whereby Business Turnover Taxes and FEECs make an increasing contribution as against relative decreases in the revenue from customs duties.

Within the category of income based taxes, separate figures for corporate and noncorporate income taxes are available only for three years (Appendix 1.2). In each of these years, corporate taxes have provided more than twice the revenue received from non-corporate income taxes. Comparative figures for the U.K. [186] show that non-corporate income taxes in this country produce three to four times the revenue received from corporate sources. This difference illustrates the comparatively low taxable capacity of Sri Lankan individuals and the consequently greater reliance placed on corporate income taxes.

Three main types of incentives have been offered through the tax system in this period: viz. accelerated depreciation allowances to all business activities and selective tax holidays and investment reliefs to both individuals and limited companies. The Sri Lankan government has also entered into treaties for the relief of double taxation with a number of other governments. Unfortunately no statistics are available as to the revenue implications of these measures.

All direct taxes are administered by the Department of Inland Revenue functioning under the Ministry of Finance. The Minister of Finance who is responsible for fiscal policy of the government usually announces intended changes in revenue laws as part of his annual budget speech and these are enacted subsequently. In terms of costs of collection, the administration of the Inland Revenue Department is fairly efficient. The costs of collection have dropped from 1.67% in 1965 to 1.02% in 1976. [205] Comparative figures for the U.K. show an increase from

1.39% in 1969-70 to 2% in 1978-79. (186)

Statistics of income tax payers and assessments published by the Inland Revenue Department however disclose (a) a dwindling taxpayer population, (b) mounting tax arrears and (c) a large number of disputes between the Department and taxpayers.

Appendix 1.4 lists the number of assessments issued annually (excluding additional assessments) over the study period on the four main classes of income tax payer. Not every tax payer receives an assessment once every twelve months, as administrative delays can result in irregular issues of assessment. Nevertheless the figures in Appendix 1.4 give some indication of the number of persons liable to pay income tax in each category during the study period. It can be observed that compared with 1957/58, the number of tax payers was lower in 1977/78 for every one of the categories; the steepest fall being witnessed among the non-resident companies. The index of income assessed given in Appendix 1.5 provides further supportive evidence of a decrease in both numbers of and income of non-resident tax payers.

Appendix 1.6 shows a high level of tax arrears continuing throughout the study period. Compared to a ratio of taxes in arrears to taxes collected of around 55% in Sri Lanka both at the beginning and the end of the study period, U.K. revenue statistics disclose a ratio of around 11% in each of the years 1976-1978. (187) It is not possible to ascertain from available information the possible reasons for or the consequences of such a high level of tax arrears. However it can be seen in Appendix

1.7 that a significant proportion of assessments appear to be contested by tax payers and that the average appeal seems to take over a year to be settled. It is not unreasonable to assume that a concomitant of such a high level of tax arrears and appeals against assessments must be a dissatisfied tax-payer population, though which is the cause and which the effect is not obvious.

The major problem faced by the tax authorities however is not so much the collection of arrears as discovery of evasion. It is generally agreed that tax evasion in the country is very high. (162) Tax evasion coupled with an extensive blackmarket and a well organised network of smuggling and unofficial dealings in foreign currency have resulted not only in much loss of revenue to the State but also in the undermining of control exercised by the government on the economy.

Several tax amnesties have been offered by successive governments since 1964, details of which are given in Appendix 1.8. From the statistics available for one of the amnesties (Appendix 1.8) it can be seen that evasion appears to take place in almost all areas of economic activity and that much of the tax-evaded earnings were held in the form of cash or undeclared and undervalued stocks. In a different sort of attempt to bring to the open some of the cash hoardings, the government demonetised currency notes of high value in 1970. Despite these efforts the practice of tax evasion still continues unabated.

CHAPTER 3

Survey of Sri Lanka Business Firms - Organisational Characteristics, Growth and Taxation.

A survey of business firms in Sri Lanka was carried out during 1976/77 by means of a postal questionnaire followed by personal interviews with some of the respondents to the questionnaire.

For the postal questionnaire, a sample of 300 business organisations was selected from directories of trade. The sample comprised

a) quoted public companies listed in the Rupee Companies Handbook[34] and

b) a sample of other business firms listed in the Ferguson's Ceylon Directory.[5]

An effort was made to omit from the sample, any firm the management of which was known to be represented by another firm already in the sample. Given the composition of the SL business community, where the big business establishments are controlled by a fairly small group of persons with some individuals holding control in several companies, it was considered that to address several copies of the same questionnaire to any one individual would be both unproductive and likely to cause annoyance. The selective approach adopted reduced the probability of any one individual receiving more than one questionnaire in his capacity as chief executive of different firms but in consequence, the sample is not a random sample. Details of the response rate are as follows:

Questionnaires despatched (excluding those returned undelivered)	300
Responses received	74
Responses/questionnaires despatched	25%

Postal surveys of opinion by private researchers are virtually unknown in SL. Businessmen do occasionally receive questionnaires from government agencies, but responses are generally low even on these. For instance, a postal questionnaire sent out in 1974 by the Ministry of Industries and Scientific Affairs to registered industrial establishments received a response rate of 49% despite penal action being threatened against those who did not reply.(196,p.80) Given the unfamiliarity of these people with questionnaire-based research as well as the sensitive nature of the subject matter, a response rate of 25% is considered to be a satisfactory achievement.

The postal questionnaire was designed to obtain information on

a) Organisational characteristics - of age, size, management and legal form,
b) Organisation objectives,
c) Perceptions of business on environmental constraints including taxation and incentives offered by the State,
d) Rates of growth and gearing levels and
e) Perceptions of business men on the impact of taxation on growth, financing and dividend policies of business firms.

Thirty of the firms responding to the questionnaire (ie. 40% of the respondents) were interviewed subsequently with a view to obtaining

a) clarification of views expressed in response to the questionnaire,
b) further information on how taxation considerations enter into the firms' decision processes, and

c) insights into the opinion of business management on the workings of the tax system and taxpayer response in general.

A copy of the postal questionnaire is given in appendix 2. This questionnaire was drafted after consideration of theoretical expectations in the literature as well as the views of a small sample of informed persons in SL obtained at preliminary interviews.*

It is however recognised that there are many methodological limitations to this type of survey research. Criticism of survey research is made[156] [170,p.33] mainly on the grounds that

a) information generated would be subjective and probably biased by personal attitudes and role idiosyncrasies of the individual respondents,

b) interviewee bias may be reflected in responses to personal interviews,

c) people do not always speak frankly about their goals, particularly business goals, and that one is more likely to get answers about mores than about motives, and

d) the ways in which and the degree to which goals, perceptions and attitudes interact with one another and with the environment are difficult to measure.

An attempt was made however to minimise the shortcomings of survey research referred to above. Firstly, all questionnaires were addressed to the chief executives of firms, so as to reduce the possible effects of role priorities coming through in the responses. However, as far as can be ascertained, the responses of a number of firms have come from the head

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* Preliminary interviews were conducted with three managers of large business firms in SL, two professional accountants and the Chairman of the second Taxation Commission.

of the finance or accounting function, and it must be acknowledged that if professional backgrounds and role idiosyncrasies of respondents can bias results, then such a bias may be reflected in our findings.

Secondly, all respondents were assured of complete confidentiality in the handling of replies. It is reasonable to expect that such an assurance of confidentiality offered by an overseas research establishment would have encouraged a greater degree of frankness from the respondents than they would normally show in their more public utterances. Finally, as far as possible, the conclusions drawn from the results of this survey will be compared with and verified against other results obtained elsewhere in the study.

Two particular areas of limitation that remain must however be acknowledged. Firstly, for most questions in the postal questionnaire, several likely answers were suggested and the findings may be criticised on the grounds that our suggestions may have biased the response. But in all such cases, respondents were encouraged to add items of their own if our suggestions did not exactly fit their preferences. Secondly, our sample of firms is fairly small and in some cases the number of observations is inadequate to permit significant results on non-parametric statistical tests. As regards significance on statistical tests, it is customary in the social sciences to regard as significant results at a level of confidence of 0.05 or better,[20,p.125] though the validity of this rule has been questioned in recent writings.[123] In what follows, the convention has been adopted of reporting confidence levels of 0.25 or better, and treating as supportive of firm conclusions only levels of confidence of 0.05 or better.

This chapter analyses the survey responses to identify significant patterns in the relationships between (a) firm characteristics, (b) perceptions regarding tax and other environmental influences and (c) growth.

Firm Characteristics

Information obtained in regard to the main activities of the respondents, the age of the firms, form of organisation, type of management and size of firm measured in terms of the value of total assets are summarised in Appendices 3.1-3.5.

Organisational objectives

The respondents were asked to state their main objectives (up to three) and to indicate the most important from amongst these. The responses are summarised in Table 3A, ranked according to choice of the most important objective.

Maintaining a going concern was the most popular objective followed closely by maximisation of profits. Maximising employee welfare and market share figured as the most important subsidiary objectives. Those objectives originally listed in the questionnaire ranked at the top and not many respondents added new items to the list. It is not obvious whether this is because the objectives in the original list exactly matched the main objectives of the responding firms or on the other hand whether the respondents picked those items from the list that most closely reflect their own rather vague and unarticulated organisational goals. Subsequent discussions with respondent interviewees, however, point to the latter explanation.

Table 3A

Objectives (of Business Organisations)

Listed in questionnaire	Number of References	The Most Important Objective
Maintaining a going concern	53	30
Maximising profits	51	25
" market share	24	6
" owners' wealth	16	3
" value added	9	2
" employee welfare	26	1
Added by respondents		
Consumer satisfaction	3	2
Growth	3	1
Provision of openings in business for dependents	1	1
Maximising employment	1	1
Diversification	2	
Improving product quality	2	
Import substitution	1	
Service to the country	1	
Keeping name in public eye	1	
Remitting dividends	1	
Not stated		2
		74

A comparison of our results with the results obtained in two American studies of business management objectives discloses several differences in attitudes. In the first US study by England[57], 1072 managers were asked to indicate organisational goals of high importance against a list of seven items put before them by the researcher. In the other, by Dent[42], chief executives or deputy chiefs of 145 business establishments were asked to describe their goals and their statements were later classified by content analysis. The rankings of organisational objectives in these two studies are reproduced in Appendix 4.

It was seen that maintenance of a going concern is the most popular choice of objective among SL business managers, both in their list of three objectives and in their choice of the most important objective from amongst these. In the Dent study, however, the objective most nearly equivalent to the maintenance of a going concern, (viz., to operate or develop the organisation) ranked half way down the list, preceded by profit-, product- and growth-related objectives. In the study by England, 'organisational stability' ranked a joint sixth in a list of eight.

The prominence given to a maintenance objective in SL in contrast to maximising or growth objectives in the USA may be explained as being due to a difference in culture and traditional value systems. The relatively low interest among SL business in achieving high growth or making more profit may, following the work of Mc Clelland[121], be viewed as reflecting the lower 'need for achievement' observed in the traditional societies of less developed countries.

On the other hand it is possible that this difference stems from the greater hostility or instability of the environment in which SL business

operates. Organisation theory recognises that when survival of the organisation or the bureaucracy becomes threatened,

> "there is a tendency to concentrate on survival and maintenance in preference to policy making with respect to the substantive goals of the organisation".[107]

At this stage of the analysis it is possible to do no more than identify such differences in objectives and possible causal factors; but the issue will be re-examined at a later stage.

One marked similarity is however observed between the results of the SL study and that of Dent. Employee welfare is a high ranking item in the lists of three main objectives in both studies, but drops dramatically to a low ranking when only the most important objective is considered.

Relationships between organisational characteristics

The organisational characteristics summarised in appendices 3.1 to 3.5 when crosstabulated with one another and with organisational objectives revealed several interesting relationships, though some of these are only to be expected. The main relationships will be listed below and discussed in brief here as they have implications for the analyses to follow later in this chapter and elsewhere.

	Observation	Workings in Appendix	Level of[58] significance of χ^2	Comment
1.	There has been less interest from or opportunity for MNCs in new investment in SL after independence compared with colonial times.	3.6	0.025	Firm conclusion

	Observation	Workings in Appendix	Level of significance of χ^2	Comment
2.	Older firms are more likely to be diversified than the newer.	3.7	0.25	Tentative conclusion
3.	Public companies show more interest in maintaining a going concern while private firms prefer task-related maximising objectives.	3.8	0.05	Firm conclusion
4.	Owner-managers tend to choose task-related objectives while professional managers favour maintaining a going concern	3.9	0.025	Firm conclusion
5.	Business firms tend, with age, to move from owner-management to professional management.	3.11	0.005	Firm conclusion
6.	Professionally managed companies are more likely to be public companies whereas owner-managed companies tend to be private.	3.12	0.005	Firm conclusion

Of the seventy four firms replying to the questionnaire, it has been possible to identify ten as being either subsidiaries or associates of western multinational companies. These companies were either controlled by their foreign parents or were dependent upon their overseas associates

for their technology. The age of these firms suggests that there has been relatively little new interest shown by multinationals in SL after it gained independence in 1948.

About a quarter of the respondent firms are in mixed activities and this tendency to diversify increases with the age of the firm, though the differences are not statistically significant. Considering that no SL firm is a 'giant' by international standards, the high tendency to diversify is particularly significant. It suggests that diversification has been a dominant response by established, and therefore older, businesses to state controls on traditional business activities (especially those connected with the import trade and the plantations). Very few, if any, of the older firms diversified out of their traditional activities in the fifties when import controls were non-existent and selective incentives for new activities were negligible. In the sixties, controls on traditional business activities were applied with increasing severity and a greater variety of incentives were available for new pioneer activities. But it was only in the seventies when state controls took the form of threats to the very existence of established business that these firms hastened to diversify. This reaction to environmental constraints however seems to have been triggered largely among local firms: of the ten firms identified as being under multinational control, only one had made any serious attempt to diversify.

As regards objectives, public companies are more interested in maintaining a going concern than in maximising profits or similar task-related objective, whereas the majority of private companies set themselves the latter type of objective. Considering only the two most popular objectives, more professional managers prefer maintenance of a going concern

to maximisation of profits while the opposite is true of owner-managers (Appendix 3.9). This difference between management types is further heightened if other task-related maximising objectives allied to profit maximisation (ie., maximisation of owners' wealth, growth, market share and value added) are included along with profit maximisation and the total is compared against maintenance of a going concern (Appendix 3.9). A very clear relationship then emerges between management type and choice of main objective: owner-managers chose to maximise profits or similar task-related goals whereas professional managers preferred maintenance goals. The majority of owner-managed private companies chose profit maximisation as their main objective, while professionally managed public companies voted overwhelmingly for maintaining a going concern. The preferences of owner-managed public companies and professionally managed private companies lay between these extremes (Appendix 3.10).

These results lead us to ask two questions. Firstly, what causes the differences in choice of objective between the two classes of management, and secondly, could the divergent objectives in turn lead to differences in achievement and possibly even attitudes toward external environmental influences?

In answer to the first question, several possible causal factors, though by no means an exhaustive list, may be examined.

1. In the earlier comparison of US and SL business objectives it was suggested that the greater hostility and instability of the environment may have something to do with SL business being so concerned with a maintenance objective. If the two types of management in SL faced different environmental constraints the same argument could be applied to explain

differences between types of management. But there is no evidence to suggest that this is true except perhaps to the extent that professionally managed companies are largely public companies, and may have a greater degree of public attention focused on them. It may be argued that under these circumstances, public companies would tend to pick more socially acceptable goals and a maintenance objective would be preferred to a profit maximising objective. But it can be seen (Appendix 3.10) that even among public companies, professional managers are more concerned with maintenance objectives than are owner managers.

2. In the US-SL comparison it was also suggested that differences in culture could be a possible causal factor. Can differences in cultural background be an explanatory factor here? It is true that most SL businessmen would be nationals of the country but as discussed in the previous chapter, some owner managers (the mudalalis) come from a different social class from the average professional manager and hence the influence of cultural or class differences cannot be ruled out altogether.

3. It may also be argued that what we see is an effect of management's role within the organisation reflected in their perceptions of organisational objectives. Professional managers may see their role and, by extension, the objectives of the organisation they control as one of stewardship or maintenance. Moreover, their choice of organisational objective may be influenced by their own personal interests which are likely to be closer to maintenance of the organisation as a going concern (consequently facilitating

the maintenance of their power and status in the organisation, rather than to maximisation of profits or shareholder benefits.

4. Finally, differences in decision processes between the two types of organisation may contribute to a difference in objectives. In the one case we may witness the entrepreneurial objectives of an owner-manager while in the other type of organisation, decision making by consensus among a number of managers or interest groups may lead to the selection of a maintenance objective as a 'lowest common denominator' acceptable to all participants in the decision process.

The question as to whether differences in objectives affect business achievement and management perceptions of environmental influences is considered in the following sections.

Constraints on the achievement of business objectives

This section analyses perceptions of the respondent firms in relation to the influence of environmental constraints, including taxation, on the achievement of business objectives. The main constraints on business activity perceived by SL business managers, as can be seen below, stem from various actions of government. Market related factors are relatively less burdensome.

Taxation as a problem

"Would it be correct to say that taxation is or has been a problem making it difficult for your firm to achieve its objectives?": this question was answered in the affirmative by 54% of the respondents. Those who said that tax was a problem were also requested to indicate the magnitude of the problem. The results are summarised in Table 3B.

Table 3B.

Taxation as a constraint on the achievement of Business Objectives.

Taxation is	No. of responses
A major problem area	18
A fairly important problem area	22
A minor problem area	0
	40
Not a problem	34
	74

In relation to surveys of opinion on taxation, it has been suggested (15,p.137) that taxpayers tend to exaggerate the problems and burden of taxation. If this were true of the current results, then it is possible that the real perceptions of the burden of taxation are even less than the above table suggests.

Whether or not taxation is believed by a business organisation to be a constraint on the achievement of its objectives can be said to be dependent upon a number of factors. The more important determinants can be identified as the following:

1. The harshness of the tax regime.
2. Other environmental constraints prevailing at the same time: the existence of greater problems in other areas could reduce the impact of tax constraints as perceived by managers.
3. The objectives of the organisation.
4. Organisational characteristics such as size or type of activity engaged in where the revenue laws incorporate discriminatory tax burdens and/or selective incentives and reliefs.

The harshness of a tax regime is a concept that is difficult to define. Economists have attempted[14] to measure relative harshness of tax systems of different countries using selected characteristics of tax structures, but an all-inclusive measure of tax structure harshness is yet to be devised. For our purposes however, it is reasonable to assume that all businesses in SL face the same general tax environment and attempt to verify the influence of other factors on business perceptions regarding the constraining influence of taxation.

Other constraints on business

A question similar to that on taxation was addressed to the respondents in regard to other likely problem areas. The 'problem areas' said to cause significant difficulty are ranked in Table 3C according to the number of firms finding any item to be a problem. The response to the question on taxation is fitted into the table at the appropriate level.

Taxation figures prominently in this ranking, being second only to import controls as a constraint affecting respondent firms. This observation is, however, subject to one qualification. The respondents knew that the whole questionnaire was intended to elicit information on the effects of taxation on business. Also the question regarding taxation was asked separately while the other constraints were listed under one multiple question worded somewhat differently. The stated purpose and layout of the questionnaire could have created a halo effect around the question of taxation with a consequent bias to the answers relating to its harshness. If this was the case, bias affecting one would render the responses to the two questions not directly comparable. The possible direction of

Table 3C.

Constraints on the achievement of Business Objectives

Problem	Number of firms facing problem	% age of total
Listed in questionnaire		
Import controls	57	77
Taxation	40	54
Shortage of finance	35	47
Price control	30	41
Market limitations	20	27
Shortage of technical and professional skills	14	19
Labour relations	13	18
Problems added by respondents		
Supply problems - material and spares	7	9
Government intervention	3	4
Threat of nationalisation	2	3
Incompetant bureaucracy	1	1
Corruption	1	1
Climatic conditions	1	1

bias, if any, is not known and there is no evidence in the responses pointing to the presence of or direction of any such influence. However, if we accept the notion referred to above that people usually exaggerate the importance of tax as a constraint on economic activity, then taxation may in fact drop lower down in the ranking.

What is clear from these responses, however, is that most businessmen in SL consider government intervention of one sort or another to be the major obstacle to the achievement of their objectives: market considerations are less important.

Import controls were first introduced in 1959 and, except for a brief spell in the late sixties, were gradually tightened. They rank as the single biggest problem, with 77% of the respondents considering these to cause them significant difficulty. The single largest item added by respondents to the list of problems in the questionnaire relates to shortages of material which are often the result of import control regulations. Of the seven respondents listing raw material problems, four were interviewed subsequently: the raw material problems of three of these were said to be due directly or indirectly to import controls.

Ironically, it was import controls in the early period that had provided the initial impetus for most manufacturing industries in our sample. Under a policy of import substitution adopted by the government in the late fifties, protection through import controls was afforded to new industrial ventures in two ways: firstly, by the complete banning of imported substitutes and secondly, by the liberal issue of import licences to the new industries for the importation of machinery and raw materials. However, when subsequently faced with continuing balance of payments problems, the government sought to cut down even further on imports and this led to a gradual reduction in quotas for imported raw materials and spare parts available to the newly setup manufacturing industries. It is this gradual reduction in quotas that seems to have been the aspect of import controls which has made it the major constraint perceived by SL business.

Analysis of perceptions regarding taxation

At the interview stage of the survey respondents were asked to explain their reasons for their views on taxation as a constraint, and the main reason or reasons cited are summarised in Table 3D.

Table 3D.
Explanatory Factors for Perceptions on Taxation

	No. of firms
A. Taxation being a problem	
Burden high on	
Business Turnover Tax and Excise	8
Income tax	3
All taxes	3
Impact of tax on cash flows	
Liquidity problems	2
Reduction in funds for reinvestment	2
Reduced debt service capacity	1
Other	
Inadequate incentives	1
Compliance costs	1
B. Taxation not being a problem	
Availability of investment incentives	3
The presence of other, greater problems	2
Accumulated tax losses	1
Unavoidability of tax payments	1
The practice of tax planning	1
Lack of interest of top management	1
Double tax credit in home country	1

The main reasons cited are extremely varied and do not lend themselves to easy classification. Nevertheless, it can be seen from the above list that Business Turnover tax (BTT) was the most commonly mentioned problem area in taxation. As against 8 interviewees referring to BTT as the main problem, only 3 firms mentioned direct income taxes. A number of firms said that the higher prices necessitated by increases in BTT rates had depressed demand for their products. One manager added that reduced demand had in their case led to further price increases to cover capacity costs.

Discussion revealed two main underlying causes for the perception of BTT as the major constraint. The first was its variability. BTT (which is a cascade tax) was introduced in the early sixties, and had increased sharply in only a few years to relatively high rates.(138) The top rate of BTT, which at its introduction was 3%, had risen to 48% at the time of the interviews. It can be observed from Appendix 2.2, that in the 10 years to 1976, revenue from BTT had risen 18 fold whereas in the same period revenue from income taxes had increased only just over 3 fold. In fact in 1976, the revenue from BTT exceeded the revenue from corporate income taxes. The second reason for a higher level of discontent in regard to BTT was that some firms felt they were able to influence their income tax payments by means of appropriate tax planning whereas the burden of BTT could not be influenced by the firms at all.

What is perceived as a high tax level appears to be determined with reference to past tax levels experienced by the firm, though the comparisons were often vague and unquantified. In their assessment of SL taxes, international tax levels appear to be of no concern to most interviewees; only two interviewees (both multinationals) made any reference to tax levels in other countries in this context.

Liquidity problems caused by tax payments were mentioned by two of the interviewees. But answers to other questions pointed to liquidity effects being a fairly common problem for SL business. The cashflow difficulties relating to taxation apparently stem largely from 'lumpy' tax payments which were said to create recurring liquidity crises. It is however possible to view these liquidity problems as being caused not so much by tax payments (which are made in arrears) but by inadequate cash flow planning within the firms.

A somewhat different perspective of the tax effects on liquid funds was offered by one interviewee who said that high taxes restricted debt servicing capacity of the business and hence its ability to borrow for new investments. This comment reveals an aspect of tax effects on capital structure to which little attention has been paid in the literature. Discussion of the relevance of taxation in the debt/equity decision focuses largely on the tax deductability of debt interest[190,p.250] and the resultant advantages to equity holders. It is recognised that bankruptcy costs[23] and agency costs[132] could counter tax advantages of debt; but the discussion revolves round the long term optimum capital structure. Even if a firm seeks to achieve a long term optimum capital structure, it is still necessary for it to be able to service its debt in the short term and to be able to meet interest and capital repayments at regular intervals in the short run, and liquidity problems (possibly aggravated by current tax payments) can prevent a firm achieving an otherwise desirable level of gearing.

In their comments it was possible to observe widely differing perceptions on the part of business managers of the same tax system facing all of them. For instance, two interviewees explained their reasons for considering tax to be a problem as stemming from the fact that taxation

reduced capital formation while two others who said that it was not a constraint were of the opinion that a system of direct taxation which offered many investment incentives was not a problem to a growing company. Other examples can be observed in Table 3D.

We also have an indication that organisational perceptions of taxation and other aspects of the business environment may be influenced by organisational characteristics. The evidence came from a finance manager of a family firm where the chief executive and the majority of top management were members of an extended family, working only part-time for the company. The firm, now in its third and fourth generation of family ownership, was only of small financial interest to any of the top management. The interviewee felt that these members of the family "did not take any problem seriously" as their own personal stake in the firm was small relative to their other business and professional interests.

Only one interviewee mentioned compliance costs as a major problem: in their case the difficulties were said to be concerned mainly with completing annual tax returns. Significantly, this was also the only interviewee who admitted to tax evasion. The examples of his evading techniques given by him however appeared to be extremely short-sighted and may actually contribute to his compliance costs in subsequent years when it would be necessary to reconcile returns for these years with past declarations.

On the whole, the analysis in this section suggests that:

(a) indirect taxes are a greater problem to business than are direct taxes,

(b) liquidity effects of taxation are an important consideration,

and (c) perceptions regarding taxation may be influenced by characteristics of the firm.

Organisational characteristics and perceptions of Environmental Constraints

The analysis which follows suggests that perceptions of business managers regarding environmental constraints may be influenced by organisational characteristics of the firms concerned. The main observations in this section are as follows:

	Observation	Workings in Appendix	Basis	Comment
1.	The smallest firms are, in general, less sensitive to environmental constraints than are the larger firms.	3.13	Index of sensitivity.	Tentative conclusion.
2.	Financial problems are a greater constraint for the smallest firms when compared with the larger firms: and for the newest firms when compared with the older firms.	3.13 and 3.14	Ranking.	Extremely tentative conclusion.
3.	Financial problems trouble owner-managers more than they do professional managers.	3.15	χ^2 significant at 0.025 level.	Firm conclusion.
4.	Profit-maximising firms are more sensitive to tax problems than those whose objective is to maintain a going concern.	3.16	χ^2 significant at 0.25 level.	Tentative conclusion.
5.	Among owner-managers, profit maximisers are more sensitive to taxation than those who maintain a going concern. (No such difference is observable among professionally managed businesses.)	3.17	χ^2 significant at 0.1 level.	Tentative conclusion.

Appendices 3.13-17 set out results of the crosstabulations of perceptions of environmental constrains against organisational characteristics. Rankings of the different environmental constraints based on the perceptions of each class of organisation are presented as well as an index of sensitivity 'I', on all constraints, where

$$I = \frac{\text{Total of all constraints affecting respondents in class}}{\text{Number of respondents in class}}$$

Size v Constraints (Appendix 3.13)

The smallest (Class 1) firms have fewer problems and different rankings of constraints as against other classes. Financial problems head the list for the small firms. Import controls which are ranked first by the larger firms are not a problem at all to the smallest class.

Age v Constraints (Appendix 3.14)

There are marked differences in the rankings of individual problems among the newest firms (less than 5 years old) compared with the older classes. By far the most common problem among the new firms is the shortage of finance whereas import controls rank first among the older firms. Shortage of finance is ranked only in the 3rd or 4th place by the older firms. Market limitations are another factor which is listed as a problem by the older firms while it is not a problem at all to the newest businesses.

Shortage of finance being a greater problem to new firms and small firms may be interpreted to signify

a. their relative lack of access to sources of finance(7),
b. the disinclination among bankers to lend on projects rather than on collateral(8), and/or

c. the greater financing needs in the case of new companies and their consequent preoccupation with financing problems.

Taxation is a relatively small problem to the newest and smallest firms. Interview discussions suggest that this is likely to be the result of the newer firms enjoying either tax holidays or brought forward tax depreciation allowances and the smaller firms paying lower rates of tax than the larger on account of concessional, small company rates.

The fact that market limitations are no problem at all to new firms suggests that they have gone into areas of activity where ample market opportunities existed and that these conditions have not changed in the short time since inception. All observations relating to the smallest and the newest firms are however of limited significance on account of small sample size.

Management v Constraints (Appendix 3.15)

The index of sensitivity to constraints is identical for the two classes of management, but there are differences of perception in relation to individual environmental variables. Taxation and shortage of finance are greater problems to owner-managers than to professional managers while price controls trouble professional managers more. It must be noted, however, that only the differences relating to finance are significant on the χ^2 test. The greater sensitivity of owner-managers to financial problems is partly due to the predominance of owner-managers among the smallest and the newest firms. Price controls have been instituted in SL mainly on products manufactured on a large scale, and the high sensitivity of professional managers to price controls is attributable partly to the concentration of these managers among larger firms.

Corporate objectives v Constraints (Appendix 3.16)

Crosstabulating constraints against the most important organisational objective shows a higher index of sensitivity to environmental constraints among profit maximisers when compared to those who seek to maintain a going concern. The profit maximisers are particularly concerned about taxation and financial problems.

Further analysis (appendix 3.17) of attitudes to tax problems by reference to both the main objective and type of management shows that profit maximising owner-managers are more sensitive to tax constraints than owner-managers seeking going-concern maintenance. Among professional managers, the pattern is reversed, although the difference between the two classes of professionals is not statistically significant.

In summary, differences observed in perceptions of business managers in regard to environmental constraints appear, in some instances, to be systematically related to internal organisational characteristics. The differences observed in sensitivity to taxation, though not very significant statistically, are related mainly to differences in type of management and their objectives.

INCENTIVES

Concurrent with the many controls - fiscal and other - imposed by government are a number of incentives offered by the State to private enterprise. The results analysed below suggest that SL businessmen have found tax incentives offered by government to be more useful than non-tax incentives and that within tax-incentives, capital allowances have been more useful than tax holidays.

Respondents were asked to indicate which, if any, of the main business incentives offered in SL (described in Appendix 5) had, in their opinion

made a significant contribution to the growth of firms in their area of business. They were further requested to specify the one or two incentives which they thought had been the most useful. The responses are summarised in Table 3E, ranked according to relative usefulness as measured by the number of times an item was specified as one of the two most useful incentives.

Table 3E.

Incentives Useful to Business Firms

Incentive	Number of respondents who believe the incentive: A Made a contribution to business growth.	B Was one of the two most useful.
+ Lump sum depreciation	63	39
+ Tax holidays	41	22
+ Development rebate	47	14
Convertible rupees	41	13
Foreign exchange entitlement certificates	32	10
Cash subsidies	9	4
+ Investment relief	19	2
Guaranteed prices and State marketing services	5	2
SUMMARY	%age of positive responses on A	B
+ Tax-related incentives	66	72
Exchange related incentives	28	22
Other incentives	6	6
	100	100

+ indicates tax-related incentives

Tax-related incentives head the list and as shown by the summary in Table 3E, are believed on the whole to have been much more useful than the non-tax incentives. The most popular incentives are seen to be capital allowances (lump sum depreciation and development rebate) given on the acquisition of fixed assets. Only two non-tax incentives were listed in the 'most useful' category by 5% or more of the respondents: both these related to concessions on currency exchange controls, while the more popular of the two also permitted recipients to overcome some of the constraints imposed by import control regulations.

In comparing the attitudes of business to tax incentives with that to exchange incentives, the following relationships are observed:

Observation	Workings in Appendix	Basis	Comment
1. Owner-managers are more appreciative of tax incentives whereas professional managers find exchange incentives to be more useful.	3.18	χ^2 significant at 0.05 level	Firm conclusion
2. The appreciation of tax incentives relative to exchange incentives is greater among firms who are troubled by tax constraints, as against those for whom taxation is not a problem.	3.19	χ^2 significant at 0.025 level	Firm conclusion

Owner-managers are more appreciative of tax incentives than are professional managers, though the tax structure itself does not discriminate

between the two types of management with respect to incentives offered. Owner-managers were found earlier to be somewhat more sensitive to taxation as a constraint on the achievement of their objectives. It is possible that in regard to incentives too, the difference lies in the attitudes of managers more than in any difference in the tax systems. Owner-managers who are more aware of the constraining influence of taxation, may over the years have benefitted more from tax incentives largely on account of their own efforts at tax minimisation.

The above inference in regard to differences in attitude between management types is reinforced by the fact that, on the χ^2 test (see Appendix 3.19), the firms which find taxation to be a constraint were seen to be more appreciative of tax incentives than firms which thought taxation was not a problem. What emerges is the general conclusion that there is a greater awareness among some managers of tax influences and that this awareness extends to the constraints imposed on the business by taxation as well as to benefits to be gained from tax minimisation through the use of incentives.

GROWTH OF BUSINESS

Respondents to the questionnaire were asked to indicate the growth of their firms over a five year period. 'Growth' for this purpose was not strictly defined; instead respondents were informed that they could measure growth in terms of increase in assets, sales, employment or whatever measure was most convenient to them. The responses are summarised in Table 3F.

Table 3F.

Business Growth among respondent firms

Growth over 5 years	Number of firms
More than 100%	14
50 - 100%	13
10 - 50%	28
Under 10%	8
Not at all	11
	74

Crosstabulating growth record with other variables leads to the following main conclusions:

Observation	Working in Appendix	Basis	Comment
1. Slow growth firms are more sensitive to both environmental constraints (including taxation) and incentives than the nil growth or faster growth categories.	3.20	Index of senstitivity	Tentative conclusion
2. Owner-managed firms grow faster than the professionally managed.	3.21	χ^2 significant at 0.01 level	Firm conclusion
3. Profit or similar task maximising firms grow faster than those who seek to maintain a going concern.	3.23 and 3.24	χ^2 significant at 0.1 level	Tentative conclusion
4. Though owner-managed firms grow faster than those managed professionally, the former are more likely to feel hampered by taxation in achieving growth objectives.	3.25	Index of sensitivity	Tentative conclusion

Judging by the Index of sensitivity, slow growing (ie. growth in 5 years less than 10%) firms seem to be far more sensitive to problems, including taxation, than any other group, even the nil-growth category (see Appendix 3.20). The slow growth firms are not only the most sensitive to environmental constraints, they also show a higher awareness of the contribution to business development made by government incentives.

No obvious explanation is available for the high degree of sensitivity both to environmental constraints and to incentives shown by the slow growth firms. A probable interpretation, however, is that these firms unlike the nil-growth firms do not have one overwhelming constraint limiting their growth; nor have they benefitted substantially from one or two incentives like the higher growth classes. They must struggle against many environmental constraints and have attempted to overcome the effects of such constraints by using many available incentives without much success; hence their greater awareness of both problems and incentives.

Crosstabulation (in Appendix 3.21) of management type against growth shows that owner-managed firms appear to grow faster than those managed by professional managers. It was reported earlier that with age firms moved from being owner managed to professional management. The relationship observed between growth and type of management is however not a mere reflection of the high percentage growth levels to be expected among the newest firms. Owner-managed firms attained higher growth levels even within the individual age groups (Appendix 3.22).

It is also observed (Appendix 3.23) that firms whose main objective is profit maximisation (or maximisation of a similar, task-related objective) are more likely to achieve high rates of growth than firms setting out to maintain a going concern, though the differences are not significant at the

0.05 level (X^2 significant at 0.1 level). Comparing the highest growth group with the nil-growth group, profit and market-share maximising owner-managers dominate the high growth class while most nil-growth firms are managed by professional managers with maintenance objectives (Appendix 3.24).

A further question was asked whether taxation had been an important discouraging factor if the respondent firm had not "grown very much" in the past five years. What "grown very much" meant in terms of level of growth was, however, not indicated in the questionnaire. Eighteen out of the seventy four (ie. 25%) respondents, including three firms showing above average growth answered 'Yes'. Another interesting management-related difference was observed in the answers to this question (Appendix 3.25). The proportion of owner-managed firms to those professionally managed among the entire sample is a little above 2:1; but among firms (a) who are dissatisfied with their growth performance and (b) who consider tax an important discouraging factor slowing down growth, the proportion rises to 5:1. This is despite the fact that owner-managers have, in general, achieved higher levels of growth than professional managers.

The differences in attitudes, perceptions and levels of growth achieved by the two types of management are seen to be the most significant results in this section. It is relevant to question whether these results hold any implications for development policy, particularly fiscal policy for development of entrepreneurial activity in SL.

The theory of economic development states that entrepreneurship is a necessary input to the development process. Writers in development economics are not however agreed as to whether in the LDCs there is a lack of enterprise among the native population or whether the people of any country could

be just as enterprising as any other nation given the right environmental and institutional background.[114] It is generally accepted however that it is the duty of governments seeking economic development for their countries to promote entrepreneurial activity and to provide an institutional framework in which enterprise can be realised.

Depending on the political philosophy of a government, it may set about increasing entrepreneurial activity in the country in one of two ways, viz:

1. the government may itself take on the responsibility for entrepreneurial activity with industrial investment in the public sector, or
2. it may seek to provide assistance and encouragement to the private sector by making available incentives and other facilities including the provision of training facilities in professional and technical management skills.

In this context, more professional management is usually seen as one way of promoting greater efficiency and development in the private sector. With reference to SL, it has been argued that

> "... attitudes brought over from the family business inappropriate to a modern enterprise can persist. The top executive positions get reserved for a small group based on family ties or a common social milieu. These factors can retard the growth of the 'company type' modern business enterprise."[72]

In SL owner-managed, family controlled, businesses are discredited not only on grounds of traditionalism as above, but also on grounds of

contrariety to 'socialist' objectives of government.[201.1975]

In the past two decades the government of SL has adopted both methods referred to above, to promote entrepreneurial activity in the country. Often with the assistance of western aid-giving nations or international organisations, it has undertaken various programmes to promote training in modern professional and technical management methods.

The tax system itself does not draw a distinction between forms of management. It does, however, include minor provisions discouraging family ownership (or 'close-controlled' companies) and indirectly promoting broad-based ownership which is generally associated with professional management.[208, sec. 25(1B) and sec. 79]

The survey results indicate that owner-managers are more likely to find taxation to be a constraint on the achievement of organisational objectives than their professional counterparts. Nevertheless, they also show greater appreciation of tax related incentives. It is very unlikely that difference in attitude to taxation as a constraint between the two groups of managers can be explained as dependent upon the minor and indirect effect of the provisions in the tax law discriminating against 'close-controlled' companies. Furthermore, as ownermanagers are more sensitive to both the constraints and the incentives of the tax system it is not even possible to conclude that they have had their achievements restricted by taxation any more than the professionally managed firms. What is apparent however is a greater awareness of tax influences and possibly a greater degree of adaptation to benefit from incentives in the tax system by a group who have also proved to be more successful in terms of achievement

of business growth than the group of professional managers who are less sensitive to taxation stimuli.

These results indicate that it may be necessary, for the promotion of private enterprise in SL, for the government to

a) acknowledge the contribution made by individual entrepreneurs at the head of family business, and to encourage this more efficient sector of private business;

b) encourage greater professionalism and efficiency in the professionally managed sector by promoting a more lively share market in which managers of publicly quoted companies can be held accountable for the profitability and efficient management of such companies.

CHAPTER 4.

EFFECTS OF TAXATION ON BUSINESS DECISIONS - Survey of SL firms

This chapter examines the results of the survey of SL business firms in relation to a number of major business decision areas where taxation is likely to have an impact and attempts to draw some conclusions as to the manner in which tax considerations enter business decision processes. The decision areas examined are those relating to

1. form of business organisation,
2. investment,
3. financing,
4. profit distribution or retention

and 5. short-term operating decisions.

FORM OF ORGANISATION

The main forms of legal organisation available to business in SL are very similar to those in the UK. Business can be carried out by limited liability companies (public or private), partnerships or individual proprietorships.*

The company law of SL being largely based on the 1929 Companies Act of the UK, the terms public and private companies have more or less the same meaning as in the UK. The stringent disclosure requirements introduced into the UK law in the '60s and '70s are, however, not found in SL. Nevertheless, every limited liability company in SL is required to have its

* The co-operative society, another form of organisation, which is associated mainly with peasant agriculture has not been studied here.

annual accounts audited by an authorised auditor while a public limited company is required additionally to file a copy of its audited accounts with the Registrar of Companies.

The limited liability form of business enterprise may be said to have several advantages in comparison with other forms of organisation, viz.

1. the benefits to shareholders of limited liability for business debt, particularly relevant where all shareholders do not take part in management,
2. the consequent facilitation of equity financing, and
3. the negotiability of shares in limited companies, though restricted to some extent in private limited companies.

On the other hand, the requirement to maintain and file audited accounts may act as a deterrent against incorporation, particularly of family businesses where too sharp a distinction may not be drawn between business and personal transactions.

The income tax law in SL discriminates between the limited liability company form of business organisation and the personal forms of partnership or proprietory ownership in two ways: firstly, the rates of tax charged are different (see chapter 2) and secondly a number of tax concessions allowed to limited liability companies in the past two decades (see appendix 6) have not been available to other forms of organisation. Even within the company sector, smaller companies have always paid tax at lower rates and more recently, people's companies (companies with broad based ownership) have been charged at reduced rates.

The effect of investment incentives offered through the tax law is to encourage incorporation; but the effect of differentials in tax rates

depends on the circumstances of the organisation.

For an individual proprietor, operation of a business as a sole proprietorship could result in tax liabilities at the highest marginal rates of 80% of income. As corporate income tax rates have been between 50% and 60% for much of the past two decades (with the small company rate of tax at around half that) incorporation of his business would have resulted in a lower tax liability for a businessman paying personal income tax at marginal rates exceeding the corporate tax rate. The advantage exists in spite of the fact that there is double taxation of corporate profits paid out as dividends, as the option is available to the entrepreneur to withdraw whatever income he requires in a form that will be tax deductable for the company (e.g. as director's remuneration). For individual proprietorships and partnerships earning substantial profits therefore, there will be tax advantages in incorporation.

For the more widely held public companies, however, the position may be reversed. For these, the double taxation of corporate profits may discriminate against the corporate form; but of course the proprietory or partnership form of operation will not be a practicable option where wide public subscription to the capital of the organisation is required on account of the large size of the undertaking or other reasons.

The analysis of the effects of corporate taxation in the developed countries is carried out largely as if the corporate sector is clearly separable from the non-corporate sector of business[81], and as if the decision to incorporate a business is uninfluenced by tax considerations.[174] However, the non-neutralities arising out of the double taxation of corporate income are widely discussed.[94, Ch.12] Stiglitz acknowledges that,

"the full implications of incorporation and the economic consequences resulting from the discouragement of incorporation by the tax treatment of a corporation requires further investigation."(174)

Given the structure of corporate taxation in SL, the effect of taxation should be to encourage incorporation of high income businesses of individual proprietors and partnerships, and also of those businesses seeking tax incentives available only to limited liability companies. The evidence analysed below, however, indicates that tax considerations do not greatly influence the form of organisation of SL business.

Over 90% of respondents to the questionnaire are limited liability companies (see Appendix 3.3). This result reflects a bias in the original sample which was extracted from (a) the list of quoted public companies in the Colombo stock market and (b) the business pages of an annual directory of local information which lists only the larger, more established organisations, mainly in the corporate sector.

The thirty firms interviewed subsequent to the postal survey were asked the question 'did taxation in any way influence the form of organisation of your business?'. The replies are analysed in Table 4A.

Table 4A

Influence of Taxation on Form of Business Organisation

Form of organisation / Form influenced by taxation	Public limited company	Private limited company	Partnership	Mixed form	Total
Yes	4	4	2	1	11
No	10	5			15
Do not know/no clear answer	1	2		1	4
	15	11	2	2	30

Looked at in total, a majority of respondents do not believe that taxation considerations influenced the form of organisation of their firm: but several points of interest are revealed by the analysis.

1. Both partnership companies interviewed said that taxation did influence their form of organisation. One of these said that they changed from an individual proprietorship to a family partnership for tax reasons (ie. to reduce the overall taxes paid on the firm's profits). This had been achieved by an individual proprietor gifting partnership shares in his business to members of his family.

   The other partnership firm said that they had in the past formed and used a limited company to handle some of their sales in order to reduce the burden of business turnover tax. Neither firm believed that they had anything to gain, taxwise, from incorporation. Ownership within the extended family apparently ensured tax minimisation for them.

2. The limited liability companies interviewed were influenced by tax to a lesser extent than non-limited liability companies in their decisions relating to form of organisation and the public limited companies less so than the private.

3. Some of the companies who said that tax considerations did affect their form of organisation added qualifications to their answers, such as,

   a) yes, but not the primary concern,

   b) yes, for new business, but not known for the original incorporation,

   c) yes, for one company in the group.

4. One interviewee who answered "no" to the question added "...but we have enjoyed the advantages of profit retention at company tax rates".

The majority of firms were not influenced by taxation in deciding the form of their organisation. Given that the tax system does not treat all forms of business organisations equally, under what circumstances are the decisions as to form of organisation unlikely to be influenced by this environmental variable? Two possibilities can be identified: firstly, the promoters of the firm could have been unaware of the tax differentials; in the alternative, taxation may have been considered, but the decision itself may have been made on the basis of other, greater priorities. A 'yes' answer however is appropriate only if taxation was (a) considered in making the decision and (b) influenced the choice.

The negative answers to the question came from limited liability companies - mainly from public limited companies. It is unlikely that persons setting up this form of organisation, or their advisers, were unaware of tax influences. The likeliest explanation is that other more critical factors had dictated the form of organisation.

The formation of public limited companies would be discouraged by tax-rate differentials (though tax holiday concessions may in some cases exert a counter-influence). It is possible that the main reason for the low relevance of tax considerations among public companies was the need to obtain public contributions to capital.

The following subsidiary evidence drawn from SL sources sheds further light on the question. Statistics on business registrations are difficult to come by, but in 1971 it was reported(72) that there were 3275 limited liability companies registered in the whole island in comparison with which

82,000 partnership and proprietorship businesses were operating at the time in the Western province (one of nine) alone. It is of course possible that the majority of these non-company business units did not pay taxes. However, the published lists of taxpayers reveal that, each year, there are a large number of resident individuals who pay taxes at the maximum rates and whose income taxes (unless all their income was used in personal consumption during the year) could have been reduced substantially by incorporating their business activities. For example in the year 1969/70 when the standard rate of company income tax was 50% and the maximum rate of personal income tax stood at 80%, it is estimated from statistics published by the Inland Revenue,[205, 1970] that over 800 resident individuals with their income derived mainly from business were assessed to income tax at marginal rates reaching the maximum of 80%.

Another illustration of a slightly different nature is provided by the response of business to the "people's company" provisions added to the inland revenue law in 1976. The law provided for a 20% reduction in the rate of income tax for companies either formed with or converted to broad-based ownership. The 1977-78 annual reports of the Commissioner General of Inland Revenue[205] show that numbers of people's companies assessed at these low rates in the two years following the introduction of the law, were 5 and 2. This low response from a population of tax-paying resident companies numbering around 700 may have been due to a number of reasons, but one of these seems to have been the irrelevance of taxation influences in decisions regarding organisational form. Two interviewees mentioned administrative problems and ambiguities in interpretation of the legislation, but most interviewees were of the opinion that their ownership structure did not permit them to take advantage of people's company provisions at the time

or even in the future. None of these companies had seriously considered the possibility of changing the ownership/management structure to obtain the benefit of lower tax rates.

An important factor in the decision process appears to be the familiarity of certain businessmen with one form of organisation; tradition seems to play a fairly important part in the decision. Those who have always worked with limited liability companies will tend to form limited companies for any new activities they undertake even if there were advantages in the proprietory form of ownership, particularly in the early years of tax losses which can be set off against income from other sources. The converse situation is even more common among unincorporated business, where the owner-managers find the proprietory form with management in the hands of the extended family to be the familiar means of doing business. Examples are to be found, however, both in our survey sample and in general, of business originally carried on by individual proprietors or family partners being incorporated on taking up a major new activity, particularly where corporate status was a prerequisite for government approval, tax concessions or loan finance.

On the whole, the above findings suggest that taxation is not a major consideration in decisions relating to form of organisation of SL business.

TAXATION AND INVESTMENT

This section will (a) outline the provisions of the SL tax system which may have a direct bearing on the investment decisions of business firms, (b) discuss procedures involved in the making of investment decisions and (c) assess the impact of taxation on the decisions and their outcomes.

The survey findings analysed below suggest

(a) that taxation is not in general a significant constraint on the achievement of investment plans, and

(b) that the method of investment appraisal adopted and differences in treatment of taxation in such appraisals have no effect on the level of growth achieved, though there may be some influence on the type of investment undertaken.

The SL tax system

In general, income taxes are charged on business income at standard company rates or progressive personal rates depending on form of ownership. But within the income tax law are a number of provisions designed to give some measure of relief selectively to some kinds of business activity and investment. These incentives fall into three main categories: viz, (a) capital allowances, (b) tax exemptions or holidays and (c) investment relief.*

Quite apart from the impact of income tax incentives, wealth taxes charged in SL since the late fifties, are expected[94,p.351] to promote investment as opposed to the ownership of idle resources. The often discriminatory indirect taxes (such as business turnover tax, customs and excise duties) may also affect the direction of investment, but the variations and combinations of indirect taxes charged on different types of business are too complex to be taken specifically into account in a general survey of the nature undertaken here. The questions asked of the respondents were therefore about taxation in general and not a particular tax, either direct or indirect.

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* See Appendix 5 for a description of the incentives.

Survey results and discussion

Thirty of the seventy four respondents were interviewed to ascertain how taxation entered into their investment decision processes. The results are summarised in Table 4B.

Table 4B

Appraisal of Investment Proposals

Method of Appraisal	Number of firms using	Taxation in Appraisal		Number of firms which make allowance for possible future changes in Taxation
		Included	Not Included	
A. Return on Capital Employed	8	8		2*
B. Payback Period	1	1		
C. Discounted Cash Flow	5	5		1*
D. (A & B)	11	8	3	2+
E. (B & C)	1	1		
F. (A & B & C)	1	1		
	27	24	3	5
NONE	3			
	30			

* Best estimates used

\+ Best estimates used by one firm and sensitivity analysis for 5% and 10% changes by the other

Most (90%) of the firms interviewed carried out some form of investment appraisal. The most commonly used decision rule in investment appraisal was Return on capital employed (RCE), either by itself or in conjunction with

one or more other methods. The other methods used were the payback period and discounted cash flow (DCF) analysis.

The three firms who did not carry out any formal appraisal of investment proposals present interesting case studies:

(a) The first was an associate of a multinational company operating a medium-sized business in SL under near monopoly conditions. The company accountant who gave the interview said that the firm did not carry out any formal appraisals "because the managing director is suspicious of figure work". All investments were however said to be made with the approval of the foreign associate company.

(b) The second was a family partnership which had not "needed" any formal appraisals in the past ten years "as all major investment has gone into stocks".

(c) The last was again family controlled, but a limited liability company. Here the managing director and his co-director/wife did their sums in their heads. This firm also admitted to employing more than one method of tax evasion.

None of these firms show any evidence of having suffered by the absence of formal investment appraisal procedures. The first two firms achieved modal (10% - 50%) growth in the study period while the third did even better.

Of the twenty seven interviewees who carried out formal investment appraisals, the majority (24) took taxation into account in the appraisals. However, it must be noted that given the system of accelerated capital allowances in operation in SL, there is no satisfactory way of incorporating tax effects accurately into a straightforward calculation of RCE. (Appendix 7 discusses the treatment of taxation in the investment appraisal techniques

commonly used by SL business firms.) Discussion revealed that the most common treatment as regards profit was for the project returns to be calculated ignoring acceleration of capital allowances (ie., using the firm's normal accounting calculations for depreciation) and computing tax at the appropriate rate on book profits. Capital employed would be taken at the initial investment and this would be compared with what is considered the typical annual return.

The payback period, if calculated on estimated after-tax cash flows, is capable of bringing into account the advantages of tax incentives which affect cash flows within the period; though it does not take into consideration the time value of cash flows. Any cash flows (including tax cash flows) arising after payback would of course be ignored completely. It has not been possible to ascertain whether tax cash flows are brought correctly into the payback appraisals of survey respondents. If tax cash flows are correctly accounted for, then the payback appraisal used alongside RCE will to some extent overcome the inadequacies of RCE in dealing with differences between book profits and taxable profits.

The three firms who excluded taxation from their investment appraisals were all users of the combined RCE and payback methods. Their reasons for non-inclusion of taxation were given as follows:

(a) "We do not include taxes in our appraisals as we only go for tax holiday activities".

(b) "We have very heavy accumulated tax losses".

(c) "We do not take taxes into consideration as in any case one has to pay tax".

Underlying these diverse reasons is an extremely short term attitude to taxation and tax planning. However, business growth among these firms does not appear to be influenced by their failure to take tax into account

in investment planning. Only the second firm referred to performed below average in its achievement of growth. The first firm falls in the modal (10%-50%) growth class while the third achieved growth at the highest (more than 100%) level.

Of the 24 firms who took taxes into consideration in evaluating investment proposals, five firms claimed that in their computations they allowed for the possibility that future tax rates may differ from the current. Four of these firms used 'best estimates' of future tax burden, while one firm said they examined the sensitivity of RCE and payback to changes in the tax burden of 5% and 10%. One firm which used best estimates of future tax rates described their procedures in some detail and it was disclosed that in the past they had "found it necessary" to use rates other than the current rates only in respect of indirect taxes. This suggests that indirect taxes are perceived by this firm as being more unstable than direct taxes.

As a point of interest relating to multinationals operating in SL, the local subsidiaries and associates in their evaluation of investment appear to take into account only local taxes. However, they all liase with their parent or associate companies abroad on major investments and it is possible that a global view of taxation is taken by the parent company appraisers.

Another set of questions were asked of the interviewees to establish the extent to which tax variables hampered the achievement of their investment plans or depressed achievement against forecast results. Twenty four (ie. 80%) of the interviewee firms had undertaken at least one new project in the previous five years and 12 of these said their results on the last major investment were not as expected at the time of investment. The reasons for variance are given in Table 4C.

Table 4C

Reasons for variance between expected and actual results on last investment.

Results below that expected:

Bureaucratic delays:

1. Five year delay - mainly at various ministries.
2. Delay in approval will affect profitability.
3. Behind schedule due to bureaucratic delays.

Shortage of material (attributed to Government controls):

4. Shortage of raw material.
5. Construction of buildings delayed due to shortage of cement.

Other Government action:

6. Nationalisation of plantations.
7. Changes in import duty rates and currency exchange rate.
8. Lack of scope due to governmental controls.

Firm-related:

9. Management and staff problems.
10. Incorrect capacity decision.

Results better than that expected:

1. Product quality better than anticipated.
2. Foreign demand greater than estimated.

Two of the firms had achieved results better than expected. Of the ten firms whose results were worse than planned for, only one firm gave a tax-related reason for their under-achievement. The tax concerned was an indirect tax (viz. import duty) and a change in rates of tax was only part

of the firm's reasons for non-achievement of forecast results.

Delays originating from the State bureaucracy (for three firms) and shortage of material (for two firms) were at the top of the list of problems. On the whole, 8 of the 10 firms blamed the government directly or indirectly for their problems leading to underachievement on investment plans.

The interviewees were also questioned on other projects considered in the previous five years. Twenty six firms had considered other projects and eight of these had been undertaken. Twelve firms had a project 'pending' at the time of the interviews while five firms had rejected their proposals and one had abandoned the project after investment. Explanations were sought from those who had rejected or abandoned projects as to their reasons; and information on the current state of pending projects was requested from those concerned. The replies are summarisedin Table 4D.

Table 4D.

Reasons for abandonment or non-implementation of projects.

Project outcome	No. of firms	Reasons
1. Abandoned after investment	1	Bad management on the one hand and government takeover of machinery on the other.
2. Pending	5	Awaiting approval/exchange allocations.
	4	Still under consideration by firm.
	2	Delayed on account of political uncertainty.
	1	Marketing problems.
	1	Financing problems.
3. Proposal rejected	1	Threat of nationalisation.
	1	Change in government policy.
	1	Government approval refused.
	1	Marketing and raw material problems.
	1	Change in market position due to the revaluation of the SL rupee.

Once again, government action or uncertainty relating to government action and bureaucratic inaction were the major external reasons for rejection or delay of investment projects. Market-related reasons were less important in comparison, and even when met with, were seen to originate mainly from government action of one sort or another. Taxation, however, was not a causal factor for the delay or rejection of any of the projects.

Crosstabulation of the method of investment appraisal with other survey variables revealed the following:

Method of investment appraisal v growth (Appendix 8.1)

The method of investment appraisal used does not appear to have any great influence on the level of growth. Nor does the absence of formal investment appraisal have any significant effect on growth. The users of RCE as the investment decision rule comprise both the highest growth group and nil-growth group.

Method of investment appraisal v diversification (Appendix 8.2)

The method of investment appraisal used does have some influence on the type of investment undertaken by SL firms. It appears that firms which use DCF appraisal criteria, with or without reference to payback period, are more likely to diversify than the users of RCE or a combination of RCE and payback. Statistical significance on the χ^2 test is however only at a level of 0.1 , and these results must therefore be considered as being tentative.

All three firms who said they had not attempted expansion or diversification were users of RCE and payback. RCE in contrast with DCF techniques appear to promote a rather conservative approach to new investment. It is in the nature of the RCE method as generally used by the interviewee firms (ie., a typical year's earnings compared with the initial investment) to

depress returns on investment, particularly those on capital asset investments when compared with DCF returns. Working capital investment returns are reflected at higher levels and could lead to a preference for expansionary investment in working capital as against investment in new activities or in fixed capital assets. (Appendix 7 discusses this question further.)

A variety of approaches to investment appraisal and to the consideration of taxation in such appraisals were seen among the respondent firms. Most firms had well established investment appraisal practices, but it must be remembered that the respondents come from the larger, more professionalised sector of SL business and their methods are unlikely to typify the practices of the vast majority of smaller business units in the country.

A minority of firms either did not use formal appraisal procedures or did not explicitly bring taxes into account in their evaluations. They take a rather short-term view of the impact of taxation on their activities, but do not appear to have been adversely affected as a result in their achievement of growth. The results also reveal that the technique of investment evaluation used does not appear to influence the level of growth achieved. Similar results have been reported for US companies by Klammer who found no consistent significant association between corporate performance and the use of sophisticated capital budgeting techniques.(110)

As discussed in appendix 7, taxation is not treated uniformly in all the different techniques of investment appraisal; the ranking of projects on the basis of investment returns could therefore be very different from one technique to another. The RCE technique would tend to discount heavily the value of accelerated capital allowances and depress apparent returns on investment in fixed assets in comparison with returns on working capital

investment. DCF methods which do not discriminate between investment in fixed assets and working capital should, in theory, promote relatively more investment in fixed assets than would RCE decision rules. It is also not unreasonable to assume that, generally, diversification will require a higher proportion of investment in fixed assets than would expansion. The latter can be achieved also by investment in working capital for the more intensive utilisation of existing fixed asset capacity. In comparison with RCE criteria, the use of DCF techniques should therefore encourage greater diversification of business activity. This proposition is supported by the survey findings.

It must, however, be reported that there appears to be no significant difference between the users of RCE and DCF as to their appreciation of the usefulness of capital allowances in promoting business development. Capital allowances were the most popular incentive among both groups, suggesting that though the RCE method of investment evaluation may undervalue the contribution of capital allowances to project returns, the avenues for tax minimisation via capital allowances were widely appreciated by the SL business community.

Another major conclusion drawn from the analysis in this section is that taxation is not a significant constraint in relation to specific investment plans or their outcomes. Direct taxation was not a reason for disappointment on or delay or rejection of investment projects undertaken or considered by any of the interviewee firms in the previous five years. In contrast, commenting generally on the tax burden, 54% of the respondents on the postal survey found taxation to be a constraint on the achievement of business objectives (Chapter 3).

The apparent inconsistency between the two attitudes is resolved if the following aspects of the process of interaction between the tax regime and business activity are taken into account:

1. the relative stability over time of the burden of business taxation in SL (see appendix 1.3) despite the multitude of small changes to the law enacted almost every year,
2. the lowering of the overall tax burden on undertaking a new investment, under a tax regime that offers accelerated capital allowances, and
3. the low sensitivity of project returns to small changes in the burden of direct taxation, in the presence of investment incentives.

It is the opinion of eminent writers in public finance that once a tax has been in existence for some time, taxpayers arrange their affairs in accordance with the tax, and however burdensome the tax, relative to a hypothetical ideal, or taxes in other countries, it is nevertheless an acceptable tax within the tax structure in which it is found. In this connection, an oft-quoted adage is that "an old tax is a good tax".[94,p.227]

Under such circumstances it would be possible for a businessman to feel constrained by taxation in the achievement of his firm's objectives, though taxation may not be a reason for underachievement on any investment undertaken in the full knowledge of the tax law.

For an existing business, the undertaking of new capital investment, and the consequent receipt of accelerated capital allowances generally mean a lowering of the current tax burden. It has been shown[158] that 100% capital allowances will produce tax neutrality in regard to investment decisions. Capital allowances (lump-sum depreciation and development rebate) in SL during the study period on some assets were as high as 120% producing not mere neutrality but a subsidy from the fisc to the taxpayer undertaking capital investment. The absence of taxation among constraints on investment must reflect the generosity of investment incentives operating in SL at the time. It may even be possible to interpret these results as signifying the

success of a high burden/high incentive tax system in promoting new investment, or at the least in not discouraging new investment in the private sector.

The primary limiting factors on the successful undertaking of new investment appear to originate in various governmental controls; and taxation is not a significant constraint.

TAXATION AND FINANCING

Much of the discussion in the literature on the effects of tax on the capital structure of business is conducted in a world of efficient markets and arbitraging investors. In this world, if debt charges are deductable in computing taxes, then both the value of the firm and benefits to equity could be maximised by increasing the level of debt finance up to the point where the risks of bankruptcy begin to outweigh the expected benefits of tax savings (see chapter 1).

This section examines the perceptions of SL business on the importance of tax considerations in financing decisions, and seeks to ascertain the extent to which taxation influences financing decisions in a LDC with a stagnant share market and lacking in the financial infrastructure available in a developed country.

The results discussed below indicate that as perceived by business managers, taxation considerations have no significant influence on financing decisions of SL firms.

The SL tax system

In theory, SL tax laws can influence both the quantity and quality of finance available to business.

In regard to the quantity of finance, economic theory recognises the cash flow effects of taxation, whereby the funds available for investment in the private sector are reduced by taxation. Additionally, in SL, two other provisions of the law may have a bearing on finance available for business. Firstly, preferential tax exemptions are available for deposits in state-owned savings banks and on investment in treasury bonds, and consequently funds may be channelled away from business into these investments for tax reasons. Secondly, the wealth tax charged in SL is expected to encourage investment and to increase funds available for the financing of investment.

Furthermore, the tax law, by its discriminatory provisions leaves room for tax minimisation via financing alternatives. The following provisions favour the use of debt capital in preference to equity:

1. The tax deductability of interest payments favours the use of debt finance in preference to equity.
2. The provisions under which small companies (ie., companies with issued share capital of less than Rs. 250,000 and annual profits of Rs. 50,000 or less) are taxed at roughly half the standard company tax rate, favour the use of debt at the margin to retain small company status and thereby gain tax savings. This benefit may be used not only by individual investors but also by limited companies. The law permits a large company not normally entitled to small company benefits to reduce its taxes by hiving off parts of the business to 'small-company' subsidiaries.
3. Investment in some fixed assets (for instance, motor cars bought for use of executives) does not attract capital allowances. In such cases, it may be more profitable (tax-wise) for a firm to lease these assets as the lease charges are an allowable expense.

(The use of leasing, however, has been restricted by retroactive legislation introduced in 1974, whereby the leasing of fixed assets to tax holiday companies, sale and leaseback arrangements and leasing between 'connected persons' could result in loss of capital allowances to the lessor.)

On the other hand the benefits of tax-free dividends during a tax holiday and investment relief (to both individual and corporate investors) are available only on equity investments: these considerations may outweigh the benefits of debt financing described above when the investment being financed is in an activity entitled to a tax holiday or investment relief.

Survey results and discussion

"Has taxation been a consideration in your general borrowing policy decisions?" The answers to this question are summarised in Table 4D′.

Table 4D′
Relevance of Taxation in Borrowing Policy Decisions

Taxation a relevant consideration	No. of firms
Yes	17
No	51
No answer	6
	74

Only a quarter of the firms replying to this question said that they considered taxation in their borrowing policy decisions. At subsequent interviews some of the firms taking taxation into account were asked to clarify their procedures and it appears that the main aspect of taxation considered by them is the effect of tax payments on the firm's liquidity and consequently its ability to service debt. The main object apparently is not

to minimise the tax liability by using a suitable borrowing policy, but to base borrowing policy on ability to service debt from after-tax cash flows. Some of the interviewee firms had used leasing facilities to minimise taxes or to optimise on after-tax position, but these remain a small minority.

To judge the importance of tax influences against other possibly relevant factors, several variables which may affect financing decisions were listed and the respondents to the postal questionnaire were asked to comment on the relevance of these. The answers are summarised in Table 4E.

Table 4E

Factors Relevant in Financing Decisions of Business Firms

	Number of firms to whom the factor is relevant		
Listed in Questionnaire	Always	Sometimes	Total
1. Borrowing is preferred to fresh equity in order to maintain owners' control	29	12	41
2. It is quicker to borrow than to obtain owners' capital	18	20	38
3. Collateral requirements of lenders are a problem	14	18	32
4. Interest rates are unacceptably high	8	20	28
Added by respondents			
5. Exchange control restrictions	1		1
6. Central bank restrictions on lending institutions		1	1
7. Liquidity preference among investors		1	1

A comparison of the above considerations with the relevance of taxation in financing decisions must be made with caution as the wording of the two questions concerned was slightly different. Nevertheless, the response

suggests that taxation considerations influence financing decisions to a lesser extent than any of the other four factors listed in the questionnaire.

Respondents were also asked to indicate the level of debt finance compared to equity finance used in their firms on a scale provided in the questionnaire. The responses are summarised in Table 4F.

Table 4F

Use of Finance other than owners' capital*

Level	Number of firms
Greater than owners' capital	21
About the same as owners' capital	13
Somewhat less than owners' capital	8
Much less than owners' capital	18
Negligible or nil	10
	70
No answer	4
	74

* Owners' Capital is defined to include all reserves and retained profits.

Crosstabulation of gearing levels with the main factors relevant in borrowing policy decisions disclose the following relationships: (workings in appendix 8.3)

1. Ease of access to debt finance relative to equity funds is associated with high gearing (χ^2 significant at 0.005 level).
2. Similarly an interest in maintaining present owners' control tends to be associated with high gearing (χ^2 significant at 0.05 level).

The two most relevant variables (ease of access to debt and owners' control requirements) both appear to promote borrowing in preference to equity

financing as evidenced by the increased importance of these variables at the higher levels of gearing. In contrast, whether or not taxation is a consideration in making financing decisions appears to have no significant influence on the level of gearing (appendix 8.3).

At the subsequent interviews respondents were questioned on the mix of finance used in their latest investments and the reasons for using the particular mix indicated, in order to verify, indirectly, the extent to which taxation entered as a consideration in decisions relating to capital structure.

Twenty-three of the interviewees were able to give us rough proportions of the different types of finance used in their last major investment, where one had been undertaken within the past five years. The proportions of finance used on average (ignoring differences in size) are given in Table 4G.

Table 4G

Average Proportions of Finances used for New Investments

		%
Internal - Retentions of profit and depreciation funds		51
New share issue		5
Debt - Development banks	19	
Commercial banks	15	
Public deposits	3	
Mixed borrowing	7	44
		100

More than half the finance for new major investments came from internal sources. This finance mix of debt to equity of roughly 4:5 matches the pattern of the overall gearing listed in Table 4F, suggesting that there has been no marked change in business gearing patterns in recent years.

The interviewees were also asked to name the major determinants of their particular capital structures. Only one firm referred to taxation as a relevant factor in this context. They said,

"In order of preference, we use

Commercial banks - as they are the cheapest,

Debentures - for their tax advantages,

Deposits from staff - as a service to them."

Public deposits are used mainly by financial firms who, by law, are not allowed access to commercial or development bank borrowing. Many firms chose commercial bank borrowing for its convenience, ease of access or suitability to their needs, when such needs were short-term or fluctuating. For instance, a firm in the tea export trade using commercial bank borrowing as the only form of debt finance said,

"Commercial bank finance is the easiest to obtain and it suits the nature of our trade."

Development finance is most often used either because commercial bank finance is not available for the period (usually long term) required or because a loan from the Development Finance Corporation of Ceylon is the only means of getting foreign exchange. Two of the interviewees said, however, that they had rejected loans from the development bank because of the bank's requirement of a place on the board of directors. A typical remark is quoted below.

"Commercial bank loans are available only for working capital. We have used the DFCC for long term finance."

- an industrial company

Several (5 out of the 30) interviewees in commenting on the mix of finance, expressed a preference for internally generated funds. One of these said that political uncertainties made them unwilling to take on a heavy debt burden.

The picture that emerges is one of business firms generally concerned about the supply of finance, but guided as much in their borrowing policy decisions by internally imposed limits and preferences as by the availability of finance. In theory, for a firm maximising profits or shareholder welfare, taxation should be a relevant consideration in decisions relating to capital structure; though it is acknowledged that other market imperfections may counter the influence of taxation. The survey results disclose that firms rarely recognise the tax advantages of gearing as having an influence on borrowing policy, or explicitly plan for tax minimisation via optimum usage of different types of finance. Even where taxation is a relevant consideration in borrowing policy, this fact has no apparent influence on the level of gearing.

TAXATION AND PROFIT DISTRIBUTIONS

As discussed in chapter 1, taxation is seen in the literature as a market imperfection which will result in dividend policy influencing the value of the firm. A classical system of taxation is expected to promote a high retention policy in a company seeking to maximise the value of the firm.

Empirical evidence relating to developed countries does not, however, wholly support the above proposition; and this is usually attributed to the presence of other market imperfections which counter the influence of taxation. In an LDC, the absence of a well developed share market is a major factor which may moderate the impact of taxation on dividend decisions of limited liability companies.

SL tax law relating to profit distributions

Taxes are charged on corporate profit in SL on the so-called classical system with double taxation of distributed profits. Dividends are taxable in the hands of recipient individuals at their marginal rates, and a withholding tax at a standard rate of $33\frac{1}{3}\%$ is collected from the company as a tax at source.

Retained profits, on the other hand, are taxed in the shareholders' hands only when these are realised. Furthermore, such income is taxable as 'capital gains' and is chargeable at a relatively low rate: the maximum rate of tax on capital gains for much of the past two decades has been 25%.

A company can, therefore, reduce shareholder taxes under SL law by maximising retentions, but the extent to which this can be done by closely controlled companies is limited as the revenue authorities have the power to 'deem as distributed' certain undistributed profits of such companies.

There is, however, one exception to the rule that dividend minimisation also minimises taxes - that is in the case of companies enjoying tax holidays which entitle them to distribute tax-free dividends out of income arising in the tax holiday period. In these cases, if no distribution is made during the holiday period, the retained profits, as far as they give rise to capital gains on realisation, will be taxable at a later date. A ceiling has been placed on tax free dividends allowed to tax-holiday companies from 1976, but the principle still holds, within the ceiling.

A tax differential between distributed and retained profits does not arise at all in the case of partnership or proprietory businesses, as the profits of these organisations would be taxed as the income of the proprietors, whether distributed or not.

Survey results and discussion

The results of the survey discussed below show that taxation is a consideration in the distribution decision of many SL firms. But there is no evidence to indicate widespread use of dividend policy manipulation to achieve tax minimisation or share value maximisation. Liquidity effects appear to be the most important aspect of taxation influencing dividend decisions.

"Is taxation of the firm or its owners a relevant consideration in your distribution of earnings to proprietors?" The answers of survey respondents to this question are summarised in Table 4H.

Table 4H

Relevance of Taxation in Profit Distribution Decisions

Taxation a relevant consideration	No. of firms
Yes - a very important consideration	28
- a somewhat important consideration	14
- a minor consideration	2
	44
No	26
No answer	4
	74

SL firms reveal a relatively high sensitivity to tax considerations affecting profit distributions - higher than their sensitivity to tax effects on investment or financing decisions. The only tax related question in the postal survey to receive a response indicating greater sensitivity was that relating to the usefulness of accelerated capital allowances. Respondents' comments at the subsequent interviews indicated that their main concern was with the effect of taxation on liquid funds available for distribution.

An unexpected response regarding taxation influences in distribution decisions came from the non-limited liability company respondents. Four out of the five partnership/proprietorship firms said that tax was a relevant consideration in their profit distribution decisions. One of these firms was subsequently interviewed and they explained that taxation of business income (which in law is charged against the proprietors in person) was a cash flow of the firm which had to be provided for before distributions (or withdrawals) of funds could be made by the partners. It is the cash flow effects of tax payments on funds available for withdrawal, rather than any tax advantage accruing as a result of distribution policy, that was important to this firm.

Respondents to the postal questionnaire were also asked to comment on other factors relevant in distribution decisions: the three main non-tax factors listed by respondents are summarised in Table 4I.

Table 4I

Main Non-Tax Factors relevant in Distribution Decisions

Factors	Relevant (important and otherwise)	Important
Availability of liquid funds	55	45
Maintaining a steady level of distribution	45	30
Income requirements of proprietors	25	18

Liquidity is apparently the most important consideration in distribution decisions, but the need to maintain a steady stream of dividends is also a relevant consideration to the majority of respondents. Comparing the data in Table 4I with the relevance of taxation (Table 4H), it can be seen that taxation, though relevant to the majority of respondents, is a consideration less important than the 'availability of liquid funds'.

Crosstabulation of the above responses with other survey variables (appendices 8.4 and 8.5) revealed that the maintenance of a steady dividend was more important to public companies than to private companies and also of greater interest to professional managers than to owner managers. (χ^2 significant in each case at 0.005 level.) These results are however not unexpected: the informational value of a stable dividend is more likely to be important in companies with wide share ownership.

In contrast, the income requirements of the major shareholders should be of greater relevance in the owner-managed family firms. This was indeed seen to be the case among survey respondents with the concern for owners' income requirements being greater among owner-managed firms than among those managed professionally (χ^2 significant at 0.025 level). The relevance of tax consideration was, however, not systematically related to any other variable.

If taxation considerations influence dividend policy and, as previously discussed (chapter 1), dividend policy can in turn affect share valuations, then it will be true that taxation may have a bearing on corporate market valuations, via its influence on dividend policy. In order to investigate this issue, a set of subsidiary questions was asked at the interview stage.

On being asked if their dividend policy in any way affected the valuation of the company in the share market, ten interviewees commented on the

relationship between dividend policy and share prices: the others had no publicly quoted shares. Of the ten companies who commented on the influence of dividend policy on market values, seven companies believed that their level of distribution was reflected in the share valuations. However, on being asked whether their share valuations could be varied by changing the dividend payout ratio, all seven replied that they did not think this was possible. Further questioning disclosed that in their opinion, earnings rather than dividends were the main determinant of market prices.

These apparently mutually inconsistent statements can be interpreted as implying that in the opinion of these interviewees,

a) dividends are important in the market valuation of shares for their information content regarding company earnings, but

b) a change in the proportion of earnings distributed will not influence market valuations other than to the extent that it signals possible changes in future earnings.

Three public companies interviewed said that their share prices were not affected by dividend policy. The reasons given for their views were as follows:

1. "... changes in dividend have no effect on share prices as the market for our shares is very small and transactions are few in number."

2. "Dividends are unimportant. There are hardly any dividend expectations today. Asset values are more important."

3. "Dividends do not affect prices much. The majority of our shares are owned by four or five individuals: though dividends have been poor nobody is willing to sell, probably because they are awaiting better times."

The above remarks reflect the imperfect nature of the market for the shares of these public companies as well as the stagnant state at the time of the share market in general. On the whole, there was no evidence to suggest that any of the ten companies attempted to influence share valuations via dividend policy. The majority of these companies had, however, at the first stage of the survey said that taxation was a consideration in distribution decisions. Remarks at the interviews on the subject indicated that their main concern was with the extent to which corporation income tax reduced profits and liquid resources available for distribution.

Two of the private limited liability companies interviewed, however, practised an extreme form of dividend minimisation (viz. a policy of non-payment of dividend) so as to achieve tax minimisation. Both were family owned, and in both companies all shareholders were directors. The shareholders' income from the business was drawn in the form of directors' fees, salaries or bonus. Companies with wider ownership, particularly the public limited liability companies where ownership is divorced from management, were not particularly interested in attempting tax minimisation via dividend policy.

Apart from the availability of distributable profits, the main consideration in dividend decisions is the availability of liquid funds. The influence of taxation on dividend decisions is exerted largely via its effects on liquidity.

Organisational Levels of Decision-making

Another interesting finding emerging from the survey relates to the level in the administration hierarchy at which investment, financing and distribution decisions are made. Although these major decision areas are

interconnected in many respects, the decisions in all three areas are not always taken at the same level in the organisation, as seen in Table 4J.

Table 4J

Organisational Levels of Decision-making

Decision	Number of firms in which decisions are usually taken by			
	Board with Parent Co. Intervention	Board of Members of Proprietory family	Chief Executive	Head of Finance
Investment	5	16	6	
Financing		7	17	3
Distribution		22	5	

The questions to which the responses in Table 4J were received were intended to ascertain the level at which decisions were made in fact and not where legal responsibility for the decisions rests. It is however possible that the legal requirements that dividends be proposed by the directors and subsequently approved by shareholders may be a factor which causes a high proportion of distribution decisions to be reported as being made at board level.

Financing decisions are taken largely at the executive level by the chief executive or the head of finance, while investment and distribution decisions are made mainly by the boards of directors. It is possible that this apparent separation of the three types of decision would lead to the inadequate consideration of interdependencies (including tax-related interdependencies) between the three areas.

On the whole, the influence of taxation is greater on distribution decisions than on financing decisions. This difference, viewed together with the fact of the high degree of separation of the financing and distribution decisions at the administrative levels of decision making, indicates that in fact these aspects of financial management, which in theory have a large element of interdependence are treated by many SL business firms as distinctly separate decisions. It will not be unreasonable to suggest that such compartmentalisation of inter-related decision areas must increase the likelihood of suboptimum decisions in each area. The evidence from the present survey, however, does not permit any more definite conclusions.

TAXATION AND OPERATING DECISIONS

In the literature of public finance (discussed in chapter 1), the impact of taxation on operating decisions, particularly pricing and production level decisions, is hypothesised to be determined by the type of market in which the firm operates and on whether the tax in question is a general or special tax. For instance, it is argued that in the short-term a new or increased corporation income tax cannot be passed forward in price by monopolists or by firms in a perfectly competitive market. Under conditions of oligopoly where prices may not have been fixed on supply-demand interactions the possibility of prices and output being adjusted by producers to reflect changes in income taxation is recognised. It is also argued that direct taxes which are based nearer market transactions are more likely to be shifted than income taxes on which the base is further removed from the market.

Viewing the same issue from another perspective, the main decision criterion offered in the management accounting literature relating to cost-

volume-profit decisions at the level of the individual firm is that incremental benefits arising from the decision should exceed incremental costs. Costs and benefits discussed hardly ever explicitly refer to taxes and income taxes are generally implied to form a part of required return.[46] Even when taxes are discussed with reference to short term decisions, income taxes are merely depicted as a percentage adjustment to the required income such that,

$$\text{"Income before income taxes} = \frac{\text{Target after-tax net income}}{1 - \text{tax rate}}\text{"}(90).$$

This treatment would no doubt be satisfactory if all business profits were chargeable to tax in a uniform manner. But given the many incentives, disallowable items and the benefits of set-off incorporated in today's tax structures, the exclusion of income tax considerations from operating decisions or even a simple percentage adjustment to required return such as that described above could lead to suboptimum results.

The results of the survey of SL firms discussed below suggest

a) that those firms who do not budget for taxation are more likely to feel taxation to be a burden than those who regularly prepare tax-inclusive operating budgets, and

b) that income taxes are not a direct information input to pricing decisions of most SL firms and, therefore, they are unlikely to attempt to shift changes in income tax in the form of price increases in the short-term.

Survey results and discussion

The thirty firms interviewed were questioned on their operations planning procedures - specifically their budgetary procedures and the extent to which taxation entered into their annual and medium term budgets. The

responses are summarised in Table 4K.

Table 4K

Taxation in Operating Budgets of SL firms

	Budgetary Practice	In no. of firms	%age	Cumulative %age
1.	Both medium-term and annual budgets are prepared with all taxes	4	13	13
2.	Both medium-term and annual budgets are prepared, but all taxes only in annual budgets	2	7	20
3.	Only annual budgets are prepared, but with all taxes	12	40	60
4.	Annual budgets are prepared with sales taxes but not income taxes	3	10	70
5.	Annual budgets are prepared with no taxes	3	10	80
6.	No budget prepared	6	20	100
		30	100	

Seventy percent of the firms interviewed take indirect taxes into account in their annual budgets while 60% take both income tax and sales taxes. As far as can be ascertained, taking taxation into account in budgeting means that appropriate tax provisions would be included in profit forecasts and estimated tax payments would be recorded as outflows in cash budgets if these were prepared.

The answers relating to budgetary practices were crosstabulated with organisation characteristics disclosed in the postal survey, but no significant relationships were discovered which could explain the differences in

practices among respondent firms. It is found (Appendix 8.6), however, that firms who prepare annual budgets inclusive of income taxes are less likely to find tax to be a constraint on the achievement of their objectives than firms who do not use budgets at all or who do not include income taxes in their budgets (X^2 significant at 0.01 level). The above result suggests that the inclusion of income taxes in regular operations planning through budgets could contribute to a reduction in the burden of taxation perceived by business managers. In contrast, where income taxes are not built into budgets (or no systematic budgetary planning is done at all), taxation is likely to be seen as a series of difficult problems to be faced at regular intervals, year after year.

In order to verify the manner in which taxation entered into pricing decisions of SL firms, the interviewees were questioned as to the main determinants of prices charged for their products. Twenty eight of the thirty interviewees were able to provide answers to this question and each person gave one or two factors as the main determinants of product prices for his firm. The responses are summarised in Table 4L.

Table 4L

Main Determinants of Product Prices

		No. of firms referring to item		
		As main determinant of prices	As one of two main determinants of prices	Total
A.	Market demand	8	6	14
B.	Price control regulations	3	5	8
C.	Policy of State corporations	1	-	1
D.	Political factors	-	1	1
E.	Operating costs	4	7	11
F.	Indirect taxes	2	1	3

Three of the respondents said that indirect taxes were a major determinant of prices in their firms. These were all firms for whom either BTT or excise or both formed a substantial part of total cost of sales. Income taxes were not referred to as a determinant of prices by any of the respondents. The respondents for whom operating costs were a major determinant of prices were asked if taxes were considered to be part of their costs. None of these firms included income taxes in operating costs: instead, income taxes were expected to be covered by the mark-up. All but one firm, however, specifically included indirect tax payments such as BTT, excise duty and import duty, in their computations of 'cost'.

The practices of these firms clearly do not correspond to pricing behaviour of business described by Krzyzaniak and Musgrave in support of their theory of full short-run shifting of income taxes. They claim:

> "The businessman ... has been skeptical regarding the entire approach of marginal pricing. His position has been that taxes are treated as a cost when determining prices, be it as part of a 'full-cost-pricing' rule, by application of a conventional mark-up rate defined net of tax, or by pricing to meet a net of tax target rate of return. According to these formulae, a change in tax rate leads to an adjustment in price. The profits tax becomes a quasi sales tax." (112,p.2)

The firms interviewed, even if they apply cost-plus pricing rules, work on a pre-tax mark-up, which implies that prices will not change as

an immediate response to a change in income tax. Their behaviour does however support the view of Herber[86] that income tax bases are further removed from market transactions than are bases of indirect tax, thereby leading to a difference in the treatment of the two sorts of tax in pricing decisions.

Regarding income tax as part of the mark-up may mean that a change in the tax rate is not followed by an immediate adjustment to price, but it does not preclude periodic adjustment of the mark-up to take account of changes in income tax or other business outgoings covered by the mark-up. The analysis of SL company accounts in Chapter 10 suggests that tax-shifting has indeed been practised by business firms.

Examining the determinants of product prices from a different perspective, it may be argued that, if the main determinants of a firm's prices are costs or indirect taxes (items E and F in Table 4L), such a firm is relatively free to pass taxes forward in prices compared to a firm in one of the classes A - D, which will have its price levels determined largely outside the firm. Crosstabulation of firms which fell clearly into one or the other group against their sensitivity to taxation disclosed no significant difference between the groups in their perceptions of taxation as a constraint upon the achievement of their objectives (Appendix 8.7). The degree of freedom a firm has to determine its product prices and hence to shift taxes does not apparently influence the perceptions of management as to the burden of taxation. This

conclusion is, however, arrived at on the basis of a small sample of responses and must therefore be accepted with caution. Nevertheless, viewed together with results presented earlier in this thesis (in which sensitivity to tax constraints was seen to be related to organisational characteristics such as objectives and type of management), these results suggest that economic criteria alone will not satisfactorily measure the burden of taxation on business as perceived by business managers.

TAX PLANNING

Finally, a number of questions were put to the interviewees in order to discover the extent of tax planning undertaking by SL firms. The majority of firms claimed to carry out some form of tax planning, but there was no evidence, for most of these firms, of systematic and comprehensive tax planning for the minimisation of taxation in the long term or for the exploitation of incentives or inequalities in the tax structure in the achievement of corporate objectives.

Replies to the question 'do you actively practise tax-planning for minimisation of taxes?', are summarised in Table 4M.

Table 4M

Tax Planning in SL Firms

Tax planning practised	Number of firms
Yes	22
No	8
	30

Of the 22 companies who said they practised tax planning, three firms added "but not adequately", or words to that effect. Two of the eight firms

who said they did not practise tax planning explained that they had no need to do so on account of brought-forward tax losses. The remarks of these two firms again illustrate the short term view of taxation influences taken by some SL firms, and their apparent failure to recognise the time-value of tax losses and tax allowances.

Examples of tax planning activities described by interviewees fall roughly into four broad classes, viz:

1) planning tax-free benefits for management, particularly for owner-managers,

2) planning for capital allowances, often an 'end-of-year' exercise in order to reduce current taxes,

3) planning related to new major investments, and

4) planning undertaken as a response to new tax laws.

The overall impression gained at the interviews was that most firms from time to time attempted to minimise taxes with reference to a particular aspect of their activities, but that there was no effort made by the majority to co-ordinate such tax planning exercises to achieve long term optimisation on all aspects of tax influences.

The previous section discussed budgetary practices and the treatment of tax in the operating budgets of interviewee firms. Tax planning, when carried out, is not usually a part of operations budgeting processes and appears to be undertaken on a rather more ad hoc basis. It was reported in the previous section that the use of tax inclusive budgets was associated with a lower sensitivity of respondents to the constraints of taxation. Active tax planning, however, does not show a similar association. On the contrary, firms who practice tax planning are seen to be more sensitive to tax constraints than firms who do not (appendix 8.8). This is, however, a

rather tentative conclusion as χ^2 significance is only at a 0.1 level. No conclusive evidence is available as to the reason for this difference. It is, however, not unreasonable to suggest that the regular routine of budgeting for taxes could reduce the uncertainties associated with taxation and therefore lead to a reduction in the perceived burden of taxation. Ad hoc tax planning exercises could very well be a response to perceptions of a high burden of taxation: hence the positive relationship observed between these two variables.

Conclusions

On the whole, the effects of taxation on major business decision areas appear to be not as great as anticipated in theoretical analysis. Where the influence of taxation is observed, it appears to be related largely to its immediate cash flow effects. Rational maximising behaviour in response to taxation that is expected in theory is less in evidence. In most cases the low relevence of tax influences can be attributed to the presence of other more critical factors (market imperfections) which over-ride the tax considerations. Finally, a difference is observed between the treatment of income taxes and the treatment of indirect taxes in pricing decisions suggesting that the traditional hypothesis of pricing behaviour whereby changes in income taxes will not be shifted in the short-term may apply to SL firms.

CHAPTER 5

SURVEY OF PROFESSIONAL OBSERVERS IN SRI LANKA

OBJECTIVES AND METHODS

The main objective of this survey was to obtain independent professional opinion in regard to business response to taxation stimuli. Such opinion on general questions not related to the experience or practices of particular business firms, it was expected, would

a) provide a secondary source of information on the attitudes of business firms, and

b) provide us with relatively impartial views on the response of business to taxation.

The survey method was similar to that adopted for firms. Questionnaires were sent out to 200 professional persons, whose names were extracted from a SL directory of trade and general information.(5) The addressees were mainly accountants (i.e. members of the two main professional accounting bodies in the country), but also included lawyers, bankers and senior members of the department of inland revenue and trade chambers. A copy of the questionnaire sent out to professional persons is to be found in appendix 9.

Of the 200 persons circulated, 80 replied to the questionnaire, a response rate of 40%. The postal survey was carried out in 1976/77 and was followed by personal interviews with 20 of the 80 respondents.

Not all respondents in the postal survey disclosed their occupation, but over 75% of those who replied were accountants. Of the twenty interviewees, 8 were accountants in public practice while 5 were accountants in

management positions in industry. The other interviewees were the chief executive of a multinational company, a lawyer, and three senior officers of the department of inland revenue.

A number of questions similar to those in the questionnaire to firms, but with more generalised wording, were asked in the postal survey of professional observers. The responses are analysed below.

CONSTRAINTS ON BUSINESS DEVELOPMENT

On the whole, professional observers and business managers agree on the relative importance of the main constraints on business development. However, two major differences were observed:

a) In the view of professional observers, income tax is a greater constraint than indirect taxes, whereas business managers tend to believe the opposite to be true;

b) political uncertainty appears to be less important to business managers than is believed to be the case by professional observers.

Taxation as a constraint

Answers to the question 'from your experience of business activity in your country, would you say that corporate or personal taxation has proved in the past to be a factor inhibiting business development?' are summarised in Table 5A.

Table 5A

Professional opinion on Taxation as a Constraint

Is taxation a Constraint?	No. of responses	%
Yes - a major constraint	19	24
- a fairly important constraint	48	60
- a minor constraint	4	5
	71	89
No	9	11
	80	100

A large majority of respondents felt that taxation has been a constraint on business development. The response from business firms to a similar but more specific question was reported in chapter 3. Business firms were asked 'would it be correct to say that taxation is or has been a problem making it difficult for your firm to achieve its objectives?': only 54% of the respondents said yes. It can be seen that the professional persons making general statements about the private sector feel more strongly about taxation as a constraint than do business managers answering on behalf of their firms.

Later in this section it will be seen that all questions relating to possible environmental constraints were answered positively by a higher proportion of professional observers in comparison with business managers: such a difference is indeed to be expected if it is recognised that professional observers are likely to be generalising from particular client experience.

At the subsequent interviews, respondents were requested to state the main reasons underlying their views on taxation as a constraint on business

development. The replies are summarised in Table 5B.

Table 5B

Explanatory Factors for views on Taxation

	No. of respondents
Taxation is a constraint because of	
Burden of income tax (corporate & personal)	11
Burden of indirect taxes	2
Uneven distribution of incentives	2
Uncertainty of taxation	1
Taxation is not a constraint because of	
Availability of double tax relief and small company relief	2
Presence of other more important constraints	1
Widespread tax evasion	1

The burden of income tax, both personal and company, appears to professional observers as the major tax constraint on business development. According to one interviewee,

> "To understand the impact of taxes on business, it is necessary to realise the total rate of tax that is effectively extracted from income. In the case of foreign companies doing business here, there is first a 60% company tax, then a 6% tax, then a 11 1/9% tax, which comes to 77 1/9%. Even after that, profits cannot be remitted without paying 65% FEECs; with the result that the total impact, on profits, of taxes amounts to 85%. This is not taxation but confiscatory legislation. When you take into account other

disallowable items and the risks involved, it certainly inhibits investment."

This interviewee included FEECs, a pseudo-tax, payable on remittances overseas as part of taxes borne by foreign investors but no reference was made to sales taxes or other indirect taxes on business.

Corporate income tax which at the time of the interviews was being charged at a rate higher than the maximum income tax rate on individuals was referred to as the major constraint by many interviewees. Two typical remarks are quoted below:

"Company taxation appears to be out of alignment with individual taxation, as the company rate of tax of 60% is higher than the marginal rate of tax on individuals."

"Company taxation discourages the formation of companies. With the formation of companies comes a certain amount of control, a disciplined way of doing business, even to the minimum extent of preparing accounts every year and having them audited."

Only two professional interviewees referred to indirect taxes among the main reasons why taxation is a constraint on business development. One of them pointed out that,

"... Business turnover tax has affected the turnover of a number of companies. This in turn has retarded their development plans. It is ironic that a number of industries that started with tax holidays were of the luxury or semi-luxury goods type and that these were subsequently saddled with high BTT rates."

In contrast, sales related taxes were referred to as the most troublesome aspect of the tax structure by 8 of the 30 business managers interviewed. Income taxes on the other hand were referred to as the major

problem by 11 of the 20 professional interviewees and only 3 out of 30 business managers.

Discussion revealed that professional observers are not unaware of the high level of business turnover tax (BTT), but that the difference in views between them and business managers stems from their belief that BTT can be, and is, shifted to consumers with little effect on the level of business activity. One interviewee went so far as to say;

> "Because BTT is a hidden tax, we find people exploiting this by building into their prices something more than the actual BTT."

The pricing practices of interviewee firms reported in chapter 4 indicate that these firms do attempt to shift BTT in prices. Nevertheless, this indirect tax remained the major problem area in taxation for business managers.

The respondents were also requested to compare the tax burden on business at the time, with that 8 to 10 years ago, that 2 to 3 years ago and that expected to prevail 2 to 3 years hence. The responses are summarised in Table 5C.

Table 5C

	Tax burden at present is				
Compared with	Much higher	Somewhat higher	About the same	A little lower	Much lower
Taxes 8-10 years ago	34	26	7	6	3
Taxes 2-3 years ago	4	18	33	17	6
Taxes expected 2-3 years from now	1	10	44	16	2

Table 5C shows that the majority of respondents believed that the burden of taxation at the time was higher than the burden 8-10 years ago but was about the same as that existing 2-3 years previously and that expected to prevail 2-3 years hence. The tax burden expected 2-3 years hence was believed to match the current tax levels closer than taxes in the past.

These responses indicate expectations of little or no change in tax levels in medium-term future. Professional opinion in this respect matches the treatment of taxation in investment appraisals carried out by business. It was disclosed in the survey of business firms (reported in the previous chapter), that most investment appraisals by SL business are done on the assumption that current tax levels will prevail during the life of the investment project. Professional observers take very much the same view of the future and this is done despite their majority belief that the tax burden has risen over the past ten years.

Other constraints

Professional respondents were also asked to comment on the list of six possible problem areas other than taxation: their answers are summarised in Table 5D, with the response to the question on taxation inserted to show its relative importance against other constraints.

As in the case of the question on taxation, there is a higher positive response from professionals on every environmental constraint listed in the questionnaire, but the rankings are fairly similar between the two groups (Spearman's $r = 0.857$; significance level = 0.01). The only major difference in ranking relates to the problem of labour relations which is

Table 5D

Professional opinion regarding Constraints on Business

Problem area	Professional respondents considering each factor to be a significant constraint: No.	As %age of total responses	Responses to similar questions addressed to business firms as %age of total responses
Import controls	75	94	77
Taxation	71	89	55
Price controls	67	84	41
Shortage of finance	58	73	47
Labour relations	49	61	18
Market limitations	41	51	27
Shortage of technical or professional skills	28	35	19

ranked last by business firms but higher up in fourth place by professionals. No obvious explanation for this difference is available, but it is possible to speculate that labour problems are probably not a constraint encountered by many firms, though when they do occur, they are a constraint of considerable magnitude. The relative placing of taxation as a constraint is the same in both surveys lending support to the view that businessmen surveyed did not exaggerate the ill-effects of taxation to any great extent.

Many professional respondents to the questionnaire added further items to our list of environmental constraints. These are summarised in Table 5E.

Table 5E

Additional Constraints listed by Professional Observers

Constraint	Referred to by No. of Respondents	As %age of total responses
Political uncertainty	17	21
Risk of nationalisation	12	15
Exchange controls	3	4
Government monopolies	3	4
Cultural factors	3	4
Overbureaucratization	2	3
Lack of enterprise among businessmen	2	3
Social criticism	1	1
Decrease in value of SL currency	1	1

Several interesting observations can be made in relation to the additional factors perceived as constraints on business development. Firstly, the item 'political uncertainty' added to the list by 21% of the professional respondents was not mentioned by a single business firm. On the whole more constraints were added to the list by professional respondents than by firms. Other constraints listed by professionals and not by firms were a) lack of enterprise among business men, b) social and cultural influences and c) the decline in the exchange value of the SL rupee.

The last item, the decline in the value of the SL currency, was listed by the local chief executive of a multinational who explained that with reducing rupee exchange value, the apparent profitability of local operations was reduced when converted to the currency of the parent company.

It is not to be expected that business managers will consider their own lack of enterprise to be a constraint on their business; but it is not

immediately clear why political uncertainty should appear a constraint to so many outside observers but not at all to the firms themselves, or why social/cultural factors referred to by professionals (though not to the same extent as political uncertainty) should not be thoughtof as a problem by business firms.

Subsequent interview discussions however revealed that some of these problems were perceived by business managers as falling under the more direct and specific environmental limitations listed by them, such as import controls or threat of nationalisation. For instance, one newly established firm awaiting ministerial approval as a 'pioneer industry' for tax holiday purposes admitted to being worried that if the approval was not received before the election, a change of government, or even a change of finance minister, may jeopardise their approval. But they did not include political uncertainty as a problem in their list of constraints.

On the whole, the opinionsof professional observers match the views of business managers in that the main environmental constraints on business are seen by both groups as originating in government action. Market factors are relatively less important.

INCENTIVES

Professional respondents were asked in the questionnaire to comment on the same list of incentives as business firms. The professional respondents were asked to pick the one or two incentives considered to have been most effective in encouraging business development. Table 5F summarises the replies and provides a comparison with the response of business managers to a similar question.

Table 5F

Professional opinion on Investment Incentives

Ranking by professional observers	Incentive	Professionals Most effective incentives: No. choosing incentive	Professionals Most effective incentives: %age of Total	Firms Most useful incentives: %age of Total	Firms Most useful incentives: Ranking
1	Tax holidays	54	68	30	2
2	Convertible rupees (CRAs)	40	50	18	4
3	Lump sum depreciation	19	24	53	1
4	FEECs	18	23	14	5
5	Investment relief	7	9	3	6 eq.
6	Development rebate	3	4	19	3
7 eq.	Cash subsidies	2	3	3	6 eq.
7 eq.	Guaranteed prices and state marketing services	2	3	3	6 eq.

The rankings by the two groups are not very close in this instance (Spearman's r = 0.58; not significant at 0.05 level). Tax holidays are ranked by professionals as the most effective incentive offered by government. Convertible rupee accounts rank second while lump sum depreciation and FEECs are listed next, but a long way behind the first two. In contrast, business firms on being asked to pick the two most useful incentives voted for lump sum depreciation as the most useful item on the list, followed some way behind by tax holidays. Ranked in third place by business managers was development rebate, which was picked as one of the most effective by only 4% of the professional observers, which gave it a very low ranking in their list. Another major difference is seen in respect of CRAs, ranking in second place in the professional list with 50% of respondents picking it

but ranked fourth below both lump sum depreciation and development rebate by business managers. In other words, capital allowances are valued as the most useful incentives by business firms whereas tax holidays and CRAs are believed by professional observers to have been the most effective.

Are the two sets of responses inconsistent with one another? Under a given tax regime, can the most effective incentive for business development be anything other than that which is most useful to businessmen? This apparent inconsistency between the two sets of responses can be explained if we consider the nature of the incentives and the timing of their offers.

Lump sum depreciation (an accelerated depreciation allowance) and to a limited extent development rebate (an additional capital allowance given selectively) had been available since the late fifties on acquisition of capital assets whether by new business or old and for both commencement of business and expansion. Though tax holidays had been on offer for even longer, these were only available at commencement of business for a limited period of time to approved firms or activities fulfilling a number of preconditions laid down by statute. CRAs (a more recent offer of free exchange of a percentage of foreign exchange earnings) were only available to exporters of non-traditional products.

In judging effectiveness of one incentive against another, it is very difficult to discern the impact on investment of an incentive such as accelerated capital allowances which are available universally to all business activities. In contrast, with tax holidays, investment in a given sector after the offer of the holiday can be assessed with comparative ease against investment in that sector prior to the offer. Similarly with CRAs, export statistics are available indicating spectacular increases in gem exports after the offer of liberal CRA facilities to this activity.[143]

From the point of view of business firms, not every firm has received tax holidays or CRAs but, without exception, every business investing in capital assets other than land in the past two decades would have benefitted from capital allowances. Furthermore, capital allowances are available for investments undertaken at any time, whereas tax holidays are available only for a limited period after the commencement of an approved activity. An existing firm undertaking a new activity in a tax holiday area would have to choose between the tax holiday and capital allowances on initial investment in capital assets. Capital allowances could be set off against current profits from other activities, whereas the benefit of a tax holiday has to be drawn over the holiday period as taxes saved on the profit on the new activity. For a firm already in a tax-paying position, therefore, there is a distinct current cash flow advantage associated with capital allowances which is not found with a tax holiday.

However, evidence from the survey suggests that some professional observers outside business firms may not appreciate the cash flow benefits of accelerated capital allowances to a growing company; e.g., an accountant in public practice said,

> "Tax holidays are far more valuable than lump sum depreciation. One doesn't pay any tax at all under a tax holiday."

The survey evidence also reveals a belief among some professionals that accelerated capital allowances are not an incentive at all, but one of many methods of deducting depreciation in computing profits. A lawyer specialising in tax law told us that

> "Contrary to popular belief accelerated depreciation does not save tax. On the contrary, it increases the burden subsequently.

Particularly with progressive taxation, it increases the burden of tax by allowing the income in later years to be subject to higher rates of taxation."

His argument would be valid for personal income tax payers who are charged at progressive rates, but ignores both the time-value of accelerated allowances and the fact that in a continuously growing firm, the postponement of tax arising from the acceleration of capital allowances is not a short-term postponement. Theoretically, if the firm continues to invest in capital assets year after year, the postponement can be for an infinite period.

It is relevant in this discussion also to note that in the last two decades in SL, tax holidays and CRAs have been offered to favoured activities as part of a package of benefits. Approval for tax holiday purposes has usually been accompanied by import permits for machinery and equipment and generous quotas for raw material imports during the initial years. Under such circumstances, it is possible that tax holidays which are more easily identified with a given activity than most other benefits usually given by administrative decision could be credited with attracting investment to that activity. This possibility was referred to by an accountant in industry:

"Tax holidays in my view are not very effective as generally in the commencing years business makes very little profit and more often than not makes losses ... But ... where business was approved for tax purposes, while there was no particular tax advantage over the commencing years, in my experience there was an advantage in that special attention was paid to such business and it was possible to obtain import of necessities and relaxation of other restrictions more freely."

Though professional observers are generally of the opinion that tax holidays have been more effective in promoting business development than capital allowances, most of them were critical of either the concept of tax incentives for development or its application in SL or both. The main arguments are listed below.

1. Whether tax incentives are a necessary catalyst in promoting business development was questioned. For instance,

   "Every country is trying to outbid the others by giving incentives. All these incentives have not brought us much by way of foreign investment. What people really want is a favourable investment climate. Tax incentives cannot compensate for an unfavourable investment climate and are not a substitute for a basic tax structure that is fair and reasonable."

   "What has really made a difference is CRA. Taxes - people know they can always avoid or evade."

2. The effectiveness of incentives was thought to be reduced by the uncertainty attached to them.

   "Incentives are given on a rather ad-hoc, short-term basis, except, that is, for lump sum depreciation."

   "One finance minister gives some incentive which another finance minister withdraws."

3. The uneven distribution of incentives was criticised.

   "There are many enterprises who have had relatively extended periods of tax holidays. These thrive at the expense of others which are not getting these benefits .. so that growth is very uneven."

4. Incentives through the tax system are hidden subsidies to business, and undesirable as their benefits cannot be assessed against their costs.

"If it is politically desirable to encourage hotels then let the ministry of tourism pay out of its funds the cost of hotels or 50% of the cost of hotels ..., the tax assessor is not an evaluator of benefits of the hotel industry."

5. Tax incentives are not understood by the public at large, whose funds could be channelled into business investment.

   "The position today is that people have a lot of funds for investment, but there is no investment opportunity or knowledge that investment could recoup dividends. The average man doesn't understand the byways and alleyways of tax holidays."

6. The multitude of incentive schemes have created administrative problems for the inland revenue department.

   "In fact tax assessors are called upon to spend a large part of their time in computation of reliefs as opposed to quantification of income."

7. Selective tax holidays are believed to have created opportunities for tax evasion in other activities.

   "Shifting income from taxable to tax-free areas is also a problem of some scale."

There are on record instances of such action to evade taxation or rather to bring back income earned in the black market with tax evasion into the mainstream of legal funds. For instance, CRA-cum-tax holiday benefits to the gem industry are reported to have been used to bring into the island illegally earned foreign currency funds.(143)

The main difference observed in this section between the views of professional observers and those of business managers related to the role of capital allowances. These are believed by professional observers to have

been less effective in promoting investment than other incentives offered by the State. Business managers, however, are of the view that capital allowances have been the most useful incentive they have received.

The official government view of capital allowances since the mid-seventies has also been similar to that of the professional observers, and has led to the withdrawal of all capital allowances in 1981. The present minister of finance of SL, who proposed in his 1978 budget speech to remove this benefit, speaking at the Commonwealth Institute in London in early 1979, explained the reason for his proposal as "an attempt to curb the widespread abuse of these provisions." He went so far as to say,

> "It is fairly common for businessmen to buy tractors or similar equipment only to get the capital allowances and then to keep them locked away, unused in their warehouses."

Views on budget provisions

As a further test of professional opinion on tax incentives and disincentives, the respondents were asked for their views on some of the proposals in regard to taxation announced in the latest budget speech.[201,p175] They were requested to indicate against each of seventeen proposals, the effect it was likely to have on growth of business in Sri Lanka on a five point scale. The points on this scale were described as (a) a major incentive, (b) a minor incentive, (c) a neutral provision (d) a minor disincentive and (e) a major disincentive. The responses are summarised and ranked in Tables 5G and 5H.

It will be seen from Table 5G that a proposed reduction in upper rates of individual income tax was ranked first in the list of incentives. Indeed, this was the only proposal believed by the majority to be a major incentive for business development. In contrast, a proposed reduction in the rate of

Table 5G

Budget Proposals considered to be incentives for business development

Ranking	Description of proposal	Score*
1	Reduction in maximum rate of income tax payable by resident individuals from 75% to 50% with effect from the year of assessment 1976/77.	122
2	Subject to a specified ceiling, where a person carrying on an undertaking in Sri Lanka has in the year preceding any year of assessment commencing on or after 1.4.76, brought foreign exchange into the country for the purpose of that undertaking, he will be entitled to a deduction from the income tax payable by him for that year of assessment, of an amount equal to the amount of foreign exchange brought in or 20% of the income tax attributable to the income from such undertaking for that year of assessment whichever is lower.	91
3	A company falling within the definition of a People's Company will be liable to income tax at a reduced rate of 40% of taxable income, with effect from the year of assessment 1976/77.	90
4	The definition of an approved investment for purposes of investment relief under section 16CC of the Act, has been extended to include (among others) any sum invested on or after 1st April 1975	

continued....

Table 5G (continued)

Ranking	Description of proposal	Score*
	in the purchase of new ordinary shares in a company approved by the Minister and engaged solely in the construction and sale of houses.	90
5	Subject to a specified upper limit, a company, investing in any undertaking on or after 1st April 1976, in accordance with investment plans approved by the Authorities, will be entitled to a deduction from income tax payable for that year of assessment of an amount equal to the investment or 10% of taxable income for that year, whichever is lower.	88
6	Where any person carrying on an undertaking in agriculture, fishing, mining or manufacture, has after 1st January 1976, increased the number of persons other than executives employed in that undertaking, such persons can claim a deduction (of an amount specified in the law) from income tax attributable to that undertaking.	72
7	Earnings in foreign exchange in the course of any profession, vocation or employment carried on or exercised abroad by a resident person is exempt from income tax with effect from the year of assessment 1976/77, provided such earnings less reasonable expenses are remitted to Sri Lanka.	71

continued....

Table 5G (continued)

* The 'Score' in Tables 5G and 5H is computed as follows:

Major incentive	2
Minor incentive	1
Neutral	0
Minor disincentive	-1
Major disincentive	-2

Table 5H

Budget Proposals considered to be disincentive for business development

Ranking	Description of proposal	Score
	a. Increase in the maximum rate of personal tax by 10% to give effect to a proposal in the previous budget	-97
1	b. Removal of exemption of profit on sale of gems through the State Gem Corporation, for companies incorporated after 6th November 1974.	-97
	c. Dividends declared by gem exporting companies out of earnings after 1st April 1975 will not be exempt from dividend tax.	-97
4	Dividends declared after 1.4.74 on ordinary shares by gemming companies will be exempt from dividend tax only up to 10%.	-85
5	Dividends declared by gemming companies after 1.4.74 on shares other than ordinary shares will not be exempt.	-83
6	Exemptions from income tax of an entertainment allowance received by an employee is withdrawn	-40
7	Introduction of an expenditure tax.	-35
8	Income of co-operative societies from some previously exempt sources will become liable to income tax.	-34
9	Withdrawal of tax free travelling allowances to employees of business firms.	-33
10	Every business firm is required to close accounts on the 31st March of each year.	-10

company income tax for companies qualifying as people's companies (ie. companies with broad-based ownership) was ranked third and believed by the majority to be only a minor incentive for business development.

The high ranking given to a reduction in personal income tax rates indicates the importance of personal income tax to the business sector in a country where (a) most business units are organised as individual proprietorships or partnerships, and (b) even among limited companies, the majority are controlled by a small number of individuals, usually from the same extended family.

The fact that the introduction of a lower rate of company tax was believed to be a minor incentive, is however, not to be interpreted as indicating company taxes to be altogether unimportant: subsequent interview discussions suggest that the qualifying conditions stipulated were believed to limit the value of this tax reduction to business firms. The company tax reductions were conditional upon ownership of the company being broad-based. Owners' control requirements and the inactive state of the share market were believed to preclude advantage being taken of this offer by most companies. The fact that administrative approval of individual applications was necessary before the tax reductions would be allowed was also considered a drawback. In general the value of an incentive was believed to be reduced by the requirement to obtain administrative approval. Many instances were cited of delays in obtaining approval for tax holidays and similar conditional incentives and of alleged discrimination in granting approvals.

Among otherproposals in the budget listed as incentives were three types of investment relief, a tax exemption tied to an increase in employment of non-executive staff and another exemption from income tax for

foreign earnings of professional persons. None of these were believed to be more than minor incentives.

Among the provisions believed to be disincentives (Table 5H), not one was thought to be a major disincentive. However, ranked in joint first place was a provision relating to personal income tax rates. This proposal required personal taxes to be raised for one year, to give effect to an announcement made in the previous budget speech. Its ranking as one of the proposals to have the greatest negative effect on business development, albeit as a minor disincentive, reinforces our conclusion arrived at with reference to the ranking of incentives, that personal taxation has an important impact on business activity in SL. It would not be unreasonable to suggest that the same would be true of many LDCs, where the majority of business units were unincorporated.

Ranked in equal first place under disincentives, along with the provision relating to personal tax rates, were two provisions proposing to withdraw tax holiday benefits granted in the early seventies to gem exporting companies. It was suggested by some interviewees that the withdrawal of tax holiday benefits may have adverse repercussions beyond the immediate effects on gem exporters, in that any incentives offered in the future could be viewed with suspicion by businessmen who would not expect the incentives to last beyond the term of office of the minister of finance offering them.

An expenditure tax re-introduced after a lapse of more than fifteen years was believed by about half the respondents to be a minor disincentive for business growth. The government's objective in introducing an expenditure tax was stated in the budget to be the curbing of consumption expenditure: but some of the professional respondents appeared to believe that

it would be a minor disincentive to business development as well. The exemption limits for purposes of this tax (ie. allowable expenditure) were set at fairly high levels and not many persons were expected to be affected by it.

On the whole, apart from the proposal to reduce upper levels of personal income tax, no other budget proposal was seen to have a major influence on business development. The results reflect the generally held view among professional observers that a low tax rate is superior to tax incentives as a means of promoting business development.

Financing Decisions

The response of professional persons was very similar to that of business firms in regard to their opinion on the impact of taxation on the financing of business activity. Table 5I summarises the views of professional respondents:

Table 5I

Professional opinion on relevance of Taxation in Financing Decisions

Tax considerations play a significant part in Borrowing Policy decisions of	Number of responses
All firms	3
The majority of firms	26
Some firms	37
A few firms	9
No firm	3

In the previous chapter, on the analysis of responses of business firms, it was concluded that:

1. taxation was not an important consideration in decisions relating to borrowing policy of most firms;
2. when tax was taken into account, the main factor considered relevant was the effect of tax payments on liquidity and debt service capacity, and
3. planning for minimisation of tax by suitable gearing arrangements did not appear to be widespread.

These conclusions are supported to a large extent by the views expressed by professional observers. Firstly, in the opinion of the majority of professional observers taxation is not a significant consideration in borrowing policy decisions of most firms.

In explaining their views on the subject at the interview stage of the survey, none of the interviewees mentioned tax deductability of interest payments as a relevant consideration in financing decisions. However, an officer of the Department of Inland Revenue alluded to the possibility as follows:

> "In the last two or three years, I have noticed, speaking with accountants and people like that, that they not only prepare accounts of past activities but that they give advice on tax planning. So if the client is sensitive enough and listens to his adviser, then he will get educated so to speak and begin to look at tax as a factor which ought to control his activities. I think the bigger firms do consider tax in financing decisions."

Judging by the views of professional accountants interviewed, however,

tax advantages of gearing did not appear an important consideration to them.

One accountant explained that SL businesses borrow as much as they can;

> "... especially in the areas where there are virtual monopolies, where they can sell without price controls - what is 12% on interest to such people. When, say, the ratio of debt to capital is about 5:1, what is 12% on the 5 when the whole balance comes to the 1."

The fact that the net of tax cost of interest would be lower than the 12%, said to be the average commercial bank lending rate at the time, did not appear to be appreciated by this interviewee.

Four of the interviewees commented specifically on the relevance of tax-deductability of interest payments. Only one of the four thought this would be a relevant consideration but he too added "... not that it is the major consideration."

Where taxation was taken into account, the impact on debt servicing capacity was believed to be the main consideration. Some illustrative remarks of interviewees are quoted below:

> "... if you are going to pay a 12% rate of interest (that is the average interest rate), and you have to pay back the capital after paying tax, that is difficult."

> ".... when there is a tax holiday or a mitigated incidence of tax they find it easier to repay loans, and instead of asking for more capital they are prepared to borrow, with the hope that they can repay and replace the borrowing."

Two other aspects of tax influences were described as follows:

"Liberal investment allowances enable ready collection of ordinary share capital."

- An officer of the Department of Inland Revenue.

"... there is a very large percentage that borrow just for tax purposes. They have the money, but from January to March they are running around from bank to bank, borrowing as much as possible to show in their books at year end; so as to show where they got money and to reduce their wealth tax liability and to cover up massive evasion that had been going on over the year .... They come in and say "You know I have the money, but I'd like to have this for tax purposes": and of course we are quite happy to lend to him because we know he won't default."

- A banker, discussing lending to personal borrowers.

The observations of professional observers support our conclusions on the survey of firms that the advantages of gearing for tax minimisation are not adequately appreciated by the SL business community. The impact of taxation on liquidity appears to be the main consideration when taxes are taken into account in financing decisions. Factors other than taxation are however believed to be more important.

The professional interviewees were invited to comment further on the determinants of financing policy among SL business firms. The main points emerging from the discussions are summarised below together with illustrative extracts from interview transcripts.

1. The Colombo share market was believed to be inactive and inefficient both as a secondary security market and as a source of new equity funds.

"We don't have a proper share market as such. Today we find it difficult to sell a share: sometimes you have to wait more than a month to find a buyer."

"You know the share market is dead, so it is hardly noticed. It will be the rare person who will go through a company's dividend record. Investment may today be not so much for dividends as for capital gains, using the company as a sort of haven."

"The share market has not made much impact, because even in the case of quoted companies they are closely controlled. The people who invest in shares feel that there are too many other factors in the way of the market expressing their views on performance of companies. The fact is that our Companies Ordinance is so outdated that the information to be disclosed is very little."

2. In the presence of an inefficient share market, borrowing from commercial banks is seen as the easiest alternative to finance from family funds.

"Dependence is mainly on finance by family units and bank borrowing."

"There is no well-developed capital market for the generation of funds for investment as in the west, so that the banks are a very important source."

3. The requirements of banks for collateral and their unwillingness to lend on the profitability of projects was criticised.

"Apart from established business and the newer men who have done very well, others still find it difficult to get finance. The

banks are very demanding and their procedures are very cumbersome. But for established business they can get what they want for the asking on a mere telephone call to the bank."

"Our banks don't lend on a viable proposition; but on security. You have to prove that you are worth a million before they give you ten thousand."

4. There was no agreement among interviewees as to the borrowing preferences of SL business. Many interviewees believed that SL business has traditionally been slow to borrow. Owners' control requirements were seen to be one reason for not wishing to have outside participation in capital.

"The average Ceylonese businessman is rather conservative and seems reluctant to get into debt... that may be one reason why they find it difficult to grow."

"The sector that I work in prefers to use their own money and then their own bankers .. the idea of getting other people's money and operating on it is not the norm.... Even the very successful businessmen - in the business they started they want to have control."

5. Another, more recent influence on borrowing policy was pointed out to be the Business Acquisition Act.(202)

"Businessmen borrow as much as they can when there is a risk of take-over."

Financial theory states that the higher the commercial and operating risks facing a firm, the less able it is to undertake the financial risks of gearing. For example,

> "with greater stability in sales and earnings, a firm can incur the fixed charges of debt with less risk than it can when its sales and earnings are subject to periodic declines; in the latter instance it will have difficulty in meeting its obligations... leverage may be used to boost stockholders returns, but it is used at the risk of increasing losses if the firm's economic fortunes decline."(193,p.686)

But here we see a different influence of anothermore extreme form of uncertainty on borrowing policy. In the presence of uncertainty relating to operating returns, the optimal course of action in regard to the financial structure may be to lower borrowing: but when the uncertainty relates to the survival of the firm, such as when there is a non-negligible probability of nationalisation, then the interests of shareholders are best served by maximising gearing.

The views of professional observers summarised above support, to a large extent, the findings of the survey of business firms that

(1) owner's control requirements are a major consideration in decisions relating to capital structure,

(2) borrowing from commercial banks is perhaps the easiest form of finance where owner's control requirements or inefficient capital markets rule out access to equity, and

(3) tax effects on financing of SL business are felt mainly via liquidity considerations.

PROFIT DISTRIBUTIONS

On the question of profit distributions, the professional respondents believed, by and large, that the majority of firms took taxation into

consideration in such decisions. The responses are summarised in Table 5J.

Table 5J

Professional opinions on the relevance of taxation in Distribution Decisions

Tax considerations play a significant part in distribution of profits to owners of	No. of responses
All firms	11
The majority of firms	44
Some firms	13
A few firms	7
No firm	3

The response of the professional observers supports the response from business firms in so far as taxation is thought to be a consideration for more firms in making their distribution decisions than with respect to financing decisions.

A number of aspects of the impact of taxation on distribution decisions were enumerated at the subsequent interviews. Firstly, the method of profit distribution in a private or owner-managed company was expected to be influenced by taxation in the presence of a non-refundable corporate income tax. For instance,

> "In a small private company, the directors would decide whether to take income as salary or dividends."

This ability to choose the method of profit distribution offers, to some extent, an alternative to tax minimisation via increased gearing. As

interest on personal borrowing is allowed for tax purposes, personal gearing may be substituted for corporate gearing. If at the same time corporate profits can be withdrawn in the form of management remuneration, then the net effect would be equivalent to that of corporate gearing.

The practice of timing dividend distributions to achieve tax minimisation was discussed by many interviewees. For instance according to an inland revenue official,

> "Distribution policy was affected by the earlier high rates of taxes. Companies tended to drop dividend rates or shift dividends to lower tax years; for example avoiding the high tax 1975/76 year of assessment."

This interviewee did not specify whether this practice was common to all companies or whether there was any noticeable difference between public and private companies. The analysis of published accounts of a sample of SL public companies (reported in Chapter 10), however, suggests that such a practice was not common among public companies.

The examples quoted by most professional respondents to illustrate their view of taxation as a consideration in distribution policy related to high dividend distributions by firms enjoying tax holidays, when dividends declared during the tax holiday period were exempt from personal income tax in the hands of the recipient. For instance,

> "...private companies which are family concerns, especially under tax holidays, paid dividends for tax reasons. Even some multinationals did this. They changed their depreciation policies in order to enable higher dividends to be paid and did not even mind qualifications in their audit reports."

Only one interviewee referred to the impact on liquidity of tax flows as affecting distribution decisions, by reducing funds available for distribution: this aspect of taxation was however the main tax influence referred to by business firms.

On the whole, the opinion of professional observers agrees with that of business firms that taxation is relatively more important in distribution decisions than in financing decisions, thus implying a separation of the two decision processes among SL firms. But the liquidity effects of taxes which were important to business firms were not referred to by many professional observers: dividend manipulation for tax minimisation gets more attention from the professional observers. The combined responses, however, suggest that tax minimisation via distribution policies is more common among owner-managed firms than among the professionally managed.

On the whole, the survey of professional observers confirms many of the results of the study of business firms. However, two exceptions have been observed: firstly, the appreciation of investment incentives appears to be different between the two groups, and secondly, the two groups emphasised different aspects of taxation in regard to its influence on distribution decisions.

CHAPTER 6

Taxation and LDC business - some international comparisons

The bulk of the literature dealing with the impact of taxation in LDCs falls into one of three categories. The first category takes the form of broad generalisations supported by particular, often isolated examples; such as the work of Prest.[49] Then there are the 'country studies' concentrating in depth on the tax law and response of taxpayers of a selected country; for instance the study of India by Chelliah,[28] that of Colombia by Bird[15] and studies on a number of countries by Kaldor.[106] The third category comprises comparative economic analysis of particular features of fiscal systems of different countries; such as the study of tax incentives by Heller and Kaufmann[84] and that of tax effort in LDCs by Chelliah et. al.[29] As far as can be ascertained no one has attempted an empirical investigation in which complete tax systems and their impact on taxpayers have been compared on an international basis. Any international comparisons are usually limited to one aspect of the tax legislation. Indeed, this is not surprising given the variety of taxes, tax bases, exemptions, incentives, surcharges, payment methods, etc., found in today's fiscal systems around the globe.

The analysis in the present study is mainly of the second form with particular reference to SL. The preceding three chapters reported the responses of SL business managers and their professional advisers to corporate taxation, and their perceptions of a variety of issues arising therefrom. It cannot, however, be claimed that the same responses and perceptions would be true of their counterparts in all other or even a majority of other LDCs. The findings of the SL surveys may very well be

unique to that country; having been caused by or largely shaped by historical and cultural influences and the combination of social and economic backgrounds peculiar to that nation. The influence of the socio-economic background on perceptions of taxation is recognised by Tripathy, writing on India:

> "The hostile popular approach to taxation in India is born partly of the political history of the country. Before Independence, taxation used to be looked upon much more as an instrument of political and economic domination over the country .... Even after Independence, this attitude has tended to persist."(222,p.367)

Yet it is also possible that some of the observations made in the last three chapters may be applicable to other LDCs or other countries in general. This chapter reports some international comparisons of business attitudes to verify the extent to which the attitudes and behaviour patterns observed in the SL survey may be true of other LDCs. Surveys similar to that conducted in SL were carried out (though on a smaller scale) in Malaysia and the Philippines and comparisons are made in this chapter between the findings of these surveys.

Malaysia, the Philippines and Sri Lanka have a reasonably similar development history, but as can be seen in Appendix 1.1, SL lags behind the other two countries in per capita income. Its rate of growth in the early and middle seventies is reported to have been lower than that of the Philippines. Comparative data are not available for Malaysia.

The comparisons undertaken here are intended to ascertain whether the conclusions drawn from the survey of SL business in regard to business behaviour and their response to taxation are equally applicable in Malaysia and the Philippines. In particular, an attempt will be made to answer the following questions:

1. Are there any similarities in the organisational characteristics of business in the three countries?

2. Can any generalisations be made as to the perceptions of and responses to taxation among business in these countries?

As background to the discussion, Appendix 10 provides a comparative listing of several important aspects of the tax law in the three countries.

Methods

The data used in the comparison were collected by surveys of opinions among the business communities of Malaysia and the Philippines carried out in 1977. Questionnaires similar (but not identical) to those used in SL were sent out to smaller samples of businessmen and professional accountants in Malaysia and the Philippines. The sample for Malaysia was a random selection from names and addresses of business firms and professional accounting firms made available by the Malaysian Trade Centre in London. For the Philippines, the sample of business firms was extracted from a list of leading business firms supplied by a professional contact in that country while the sample of professional observers was randomly selected from the membership list of the Institute of Certified Public Accountants in that country. Table 6A lists details of questionnaires sent out and the responses.

Table 6A

Survey Response - Malaysia and the Philippines

Questionnaires		Despatched	Returned Undeliv'd	Responses	Responses as % of questionnaires deliv'd
Business firms	- Malaysia	99	4	18	19
	- The Philippines	46	2	7	16
Professional Accountants	- Malaysia	99	10	9	10
	- The Philippines	83	10	9	12

The response rate for both Malaysia and the Philippines is lower than in SL. This low response is believed to be attributable at least in part to the fact that no follow-up action was taken after the despatch of questionnaires to Malaysia and the Philippines whereas the questionnaires in SL were followed by reminders where no replies had been received within three weeks.

The Malaysian and Philippine responses are analysed below.

ANALYSIS OF RESPONSES

Business firms replying to the questionnaire from Malaysia and the Philippines differed somewhat in organisational characteristics from the SL respondents.

Age

The SL business responses were dominated by old firms established more than 30 years ago: the Malaysian and Philippine responses came from newer firms (Appendix 11.1). It is possible that some of the difference may be attributed to non-uniform sampling methods: but a review of recent economic history of the three countries suggests that what we see here is a reflection of differences in levels of new private sector activity in these countries.

Organisation

The distinction between public and private limited liability companies is not relevant in the Philippines; the law of this country provides for one type of 'corporation'. The Malaysian sample included a higher proportion of private limited liability companies than was found in SL but the difference is not significant and probably reflects a bias introduced by the sampling procedures adopted (Appendix 11.2).

Management

The distribution of management in the Philippine sample is very much the same as in SL, but the Malaysian respondents include a much smaller proportion of owner managers (Appendix 11.3; χ^2 significant at 0.025 level). It is worth noting that the smaller proportion of owner managers in Malaysia comes from a sample which includes a relatively greater number of private limited companies. Although this cannot be taken to be conclusive evidence in view of the small samples involved, it is possible to hazard a guess that these results reflect a higher level of professionalism in the management of Malaysian companies.

Organisation objectives

The most interesting difference in organisation characteristics between SL and the other two countries relates to the choice of business objectives. The majority of SL firms included 'the maintenance of a going concern' as one of their three main objectives and over 40% of SL respondents chose this as the most important objective of the organisation. The Malaysian and Philippine firms in contrast overwhelmingly vote for maximisation of profit or similar task-related objectives (Appendix 11.4). Only one Malaysian firm out of 18 picked the maintenance of a going concern as its main objective: no Philippine firm chose this as its main objective. This difference between SL firms on the one hand and Malaysian and Philippine firms on the other in their choice of main organisational objective is statistically significant on the χ^2 test at a 0.005 level.

In Chapter 3 the objectives of SL firms were compared with those of US firms reported in two separate studies. The main difference noted between US and SL firms was also the high priority placed on 'maintenance objectives' in the latter whereas in the US there was a distinct preference among business firms for 'maximising objectives'.

The preference among business firms for 'maximising objectives' reported in the US studies is apparently not an isolated example peculiar to that country. A study of objectives of UK business carried out by The Institute of Chartered Accountants of England and Wales[95] reported findings similar to those of the US studies with 58% of respondent firms choosing profit related primary objectives as against only 10% who preferred survival related objectives. In Malaysia and the Philippines we again see objectives similar to those prevailing in the UK and USA.

What then is the explanation for the difference in business objectives observed in SL? The distinction between western developed countries and LDCs of Asia in their historical and cultural background, which was proposed as a possible causal factor in explaining the difference between US and SL business objectives can no longer be applicable. In Malaysia and the Philippines, both Asian LDCs, the objectives appear to be very similar to those of western developed country business. The Philippines differs from SL in its more recent colonial history with the colonial influences on the country coming from Spain and the USA whereas the western colonial powers influencing SL and its economic activity were the Portuguese, Dutch, and the British, in that order. The western influences on Malaysia are however similar to those on SL. One difference between SL and the other two Asian countries lies in the Chinese influence on business which is strong in Malaysia and the Philippines but absent in SL. Whether these sociological differences have anything to do with the differences in business objectives is however not known.

A major difference between SL and the other countries at the time of our survey was the attitude of government to private enterprise. SL had the most left wing government in all five countries with a coalition of

parties including the local communist party and a Trotskyist political party in power since 1970. The State had during the seventies given itself a monopoly position in a number of business activities previously carried out in the private sector and also carried out the nationalisation of the majority of the country's plantation sector as well as a number of leading industrial establishments. Although the tax law and other administrative procedures included many general or selective incentives for private sector investment and business development, the official political stance of the government was 'socialist'. The other four countries discussed, in contrast, openly (though not all to the same degree) encouraged the development of local private enterprise with little or no politically imposed constraints or uncertainties affecting survival of private sector business. The hostility of government to private enterprise at the time evident in SL is probably the main reason underlying the greater interest of SL business in survival oriented maintenance objectives.

It was reported in Chapter 3 that in SL, firms with maintenance objectives tended to be professionally managed and were also seen to have achieved lower growth levels than firms with maximising objectives. There is no indication that this would be equally true of Malaysia, where the only business firm to choose maintenance of a going concern as its main objective was owner managed and also achieved growth of over 100% in a five year period. Inadequate sample size however precludes any significant conclusions.

Whether the apparently low interest in maximising objectives among SL business is reflected in their performance relative to business in the other two countries is a question that remains to be answered.

Constraints on business

Parallel questions asked in the three surveys regarding taxation as a constraint on business elicited similar responses. A comparative tabulation of responses is given in Table 6B.

Table 6B

Comparative Perceptions of the Burden of Taxation

Taxation as a Constraint on the achievement of business objectives	No. of Firms		
	SL	Malaysia	Philippines
Yes	40	9	5
No	34	9	2
	74	18	7

Roughly half the respondent firms in SL and Malaysia perceive taxation as a constraint on the achievement of their objectives. The proportion of firms finding taxation to be a constraint in the Philippines was somewhat higher than in the other two countries but the difference is not significant given the low total response from the Philippines.

The position regarding comparative perceptions on the impact of taxation becomes clearer when perceptions of taxation are compared with perceptions of other possible environmental constraints listed in the questionnaires. Table 6C summarises the responses on non-tax constraints and provides a ranking of all constraints.

Table 6C

Ranking of Environmental Constraints

Non-tax Constraints listed in Questionnaire	No. of Firms who find item to be a constraint		
	SL	Malaysia	The Philippines
Import Controls	57	7	3
Shortage of Finance	35	5	4
Price Controls	30	3	3
Market Limitations	20	11	4
Shortage of skills	14	9	2
Labour relations	13	2	1

Ranking of all Constraints	SL	Malaysia & Philippines
Import Controls	1	4
Taxation	2	2
Shortage of Finance	3	5
Price Controls	4	6
Market Limitations	5	1
Shortage of skills	6	3
Labour relations	7	7

Spearman's $r = \underline{\underline{0.25}}$

A comparison of ranking of all constraints including taxation shows major differences in ranking of constraints by SL firms when compaired with firms from the other two countries taken together: but taxation is ranked similarly in both groups as the second most common constraint.

As regards the other constraints, the major differences between SL and the other two countries relate to (a) import controls, (b) market limitations and (c) shortages of technical and professional skills. As can be seen in the workings given in Appendix 11.5 all these differences are

statistically significant at levels better than 0.05 .

Import controls were the main problem for SL business. Malaysian and Philippine business were not troubled much by this factor: instead, market limitations were their main constraint. Shortages of technical and professional skills, though ranking further down, were more of a problem to Malaysian and Philippine firms than to SL firms. Shortage of finance was a relatively greater burden to Philippine firms in comparison with the other two countries, though the small sample size precludes statistically significant conclusions.

The main variations in perceptions of constraints again seem to reflect differences in levels of governmental controls between SL and the other two countries. The highly restrictive import controls in SL are probably seen as the limiting factor on business activity by a majority of SL business managers: but the protection afforded by such import controls against competing imports (and sometimes against competing local manufacturers) have made market considerations less of a problem to SL firms. In the more open economies of Malaysia and the Philippines, market limitations become a greater constraint. The differences in perceptions relating to shortages of skills too may very well be due to differences in the level of market competition: in more open economies, where the market is the main determinant of the success of a firm the technological and professional skills required to be successful in business are bound to be greater than in a stagnant and protected market.

Two further items were added by Malaysian firms to the list of constraints, viz: (a) increasing governmental bureaucracy and (b) corrupt officials. These echo views of some SL respondents who also added similar items to their list of constraints.

In Chapter 3 it was reported that owner-managers were somewhat more sensitive to taxation as a constraint than professional managers; but the

differences were not statistically significant on the χ^2 test at the 0.05 level. Similar results are seen in the combined Malaysian and Philippine sample (Appendix 11.6).

Incentives

Investment incentives offered through the tax systems of the three countries are not identical as can be seen in the tabulation in Appendix 10. As there appears to be even less in common between incentives offered outside the tax system in these countries, a straightforward comparison of relative usefulness of all incentives is not likely to be very meaningful. The difficulty of classifying the numerous tax incentives into clearly defined categories commonly applicable to all three countries meant that we were not able to compare the relative usefulness of all tax incentives. This section will analyse the perceptions of business relating to the two major tax incentives; viz. tax holidays and accelerated depreciation allowances.

The survey responses (Appendix 11.7) show that the level of appreciation of the two incentives is different between countries: SL business appears to find accelerated depreciation allowances to be more useful whereas Malaysian and Philippine business show a greater appreciation of tax holidays (χ^2 significant at a 0.025 level). These two types of incentive are however the most popular investment incentives in all three countries and head the list of the two most useful incentives in each country group. The explanation for the difference in ranking observed between SL and the other two countries probably lies within the tax systems of these countries. As can be seen in Appendix 10, in SL accelerated depreciation allowances are freely available to all types of business whereas in Malaysia and the Philippines acceleration of depreciation allowances comes as a selective privilege. In Malaysia accelerated depreciation allowances are available

as an alternative to pioneer status and in the Philippines these are offered only to 'preferred non-pioneer' business. Tax holiday benefits in Malaysia and the Philippines on the other hand appear to be more generous than those on offer to SL business.

A further factor contributing to the lower ranking of tax holidays in SL is probably the fact that in benefitting from a tax holiday a firm would be forgoing capital allowances otherwise available to it on its heavy initial investment. Hence a tax holiday which is a selective incentive is devalued to the extent of the opportunity cost of accelerated depreciation allowances forgone. Malaysian tax law, by contrast, permits 'Pioneer Industries' claiming tax holidays to treat their purchases of capital assets during the pioneer period as acquired immediately after the end of the pioneer or holiday period. Depreciation allowances (though not accelerated) can therefore be claimed in respect of a pioneer firm's initial investment, against profits arising after the tax holiday period. In the Philippines each incentive is offered to a different type of preferred activity.

It is also possible that the high proportion of older firms in the SL survey sample was another contributing factor to the lower ranking of tax holidays by these firms, many of whom would have commenced business long before tax holidays were offered in that country.

On the whole, the main conclusion to be drawn from the above analysis is that tax related investment incentives are highly appreciated by business managers in all three countries. Yet, there is no agreement among these country samples as to the usefulness of tax holidays and accelerated capital allowances relative to one another. The differences in perceptions as to relative usefulness of the two incentives seem to be the result of variations in benefits offered under these incentives in the three countries.

Comparing these results with other studies of effects of tax incentives,

however, we observe wide variations in both techniques and results. US studies of tax incentives were discussed in chapter 1: it was seen there that econometric models estimate significant increases in investment as a result of tax incentives,[77] while interview evidence points to a somewhat lower order of impact.[54]

Survey studies in LDCs have also produced contradictory results. In a study of regional incentives in Brazil, Goodman[217] has reported that tax incentives have had a significant impact on investment location. But other studies in Pakistan,[200] Jamaica[215] and Mexico[220] in which survey respondents were questioned about the extent to which particular investment decisions were influenced by tax incentives have reported that investment would not have taken place in the absence of tax incentives only in a very small proportion of firms.

Our survey questions, in contrast to those referred to above, were designed to ascertain views of businessmen in general regarding the relative usefulness of tax and other investment incentives; and the results show that businessmen have found tax incentives to be the most useful among the array of incentives offered by their respective governments. These results can be reconciled with those of other studies showing a low impact of tax incentives on specific investment decisions if we accept the possibility that tax incentives may be useful in channelling investment into preferred activities or locations, but that the main determinants of investment levels lie outside the tax system.

Growth of Business

Achievement of growth by Malaysian and Philippine firms exceeds that of the SL firms surveyed (Appendix 11.8). SL has proportionately more nil and low growth firms (χ^2 significant at 0.1 level) and the lowest growth

index of the three countries. The difference between SL and Philippine firms also corresponds to the difference in growth of per capita income referred to earlier.

The analysis of SL survey results in Chapter 3 indicated that firms with profit maximising or other similar maximising objectives achieved higher growth levels than did firms whose main objective was the maintenance of a going concern. As reported earlier, none of the Philippine firms and only one Malaysian firm had the main objective of maintaining a going concern. These two relatively high growth samples voted overwhelmingly for task-related maximising objectives. Though direct evidence is not available, it would not be unreasonable to suggest that both the emphasis on maintenance objectives and lower business growth levels observed in SL are at least partly caused by the tighter control over private sector activity exercised by the government and the greater environmental uncertainty created by actions of the State in that country.

It was reported in Chapter 3 that among SL business, owner-managed firms tended to grow faster than those managed by professional managers. The corresponding data for the Philippines is too small to draw any conclusions: but it is observed that in the Malaysian sample, the pattern is reversed and professionally managed firms achieve higher growth levels than do the owner-managed. This observation is based on comparative growth indexes (Appendix 11.9) and must be treated as tentative.

That there may be differences between management types in their decision making processes[166,p.382] and achievement[216] is however acknowledged in the literature. Western, developed country experience appears to be that in large corporate organisations in high technology activities, professional management is generally more successful than owner-management. Galbraith[216] gives many examples in the US context.

According to our results the corporate growth record in Malaysia matches US experience; but the pattern in SL is the reverse of this.

Researchers into the history of entrepreneurial behaviour argue that entrepreneurial activity can be a function of many socio-economic influences from the environment.(199) One such variable affecting entrepreneurial activity is said to be the stability of the investment climate. As already discussed, unlike in Malaysia, the business environment in SL in the years preceding the survey had been both unstable and increasingly hostile. No attempt has been made here to identify all causal factors for variations in corporate growth. However, one possibility that cannot be ruled out is that when environmental conditions (particularly socio-political conditions) are stable, then professional bureaucracies work at their most efficient; but that they are less able than individual entrepreneurs to cope with unfavourable changes in political background or with hostile social influences. Though it may be true that professional management is more efficient in large high-technology industrial corporations in market economies, for an LDC with low technology small industries, and a high level of governmental control, the traditional forms of proprietory business may prove to be more adaptable and efficient in the early stages of development of the country. The growth record of SL business supports this proposition.

Though no interviews were carried out in Malaysia and the Philippines one Malaysian firm (owner-managed and reporting no growth in five years) enumerated, by letter, their particular problems in achieving expansion of business. Two main constraints were mentioned by this firm, viz. (a) corruption in official circles and (b) discrimination on religious and ethnic grounds. As regards corruption, the owner-manager of this firm wrote

"... if you are prepared to consider rampant corruption as

being 'taxation' in one form or other, then I feel that this should be included in your findings. We, as a firm have consistently refused to corrupt in any way, with the result that some of our competitors, including the previously respectable British firms with world-wide connections, are able to import on the one hand through the Custom Department here, goods wrongly declared and therefore attracting lower import duties. These firms are also increasing their sales turnover by developing important sales to State Government supported corporations by corrupting purchasing officers of these organisations. All these of course affects our own sales turnover and is partly responsible for our continuing lack of growth."

As regards discrimination, he believed that a British engineer employed by him had had his work permit cancelled on account of his connections with a Christian organisation in this Islamic country and that the firm itself was being discriminated against as it was owned by a European immigrant.

The SL government was similarly accused in the SL survey of discrimination against ethnic minorities in that country; but it must be recognised that the discrimination that the above respondent complains of is part of official policy in Malaysia where the government as part of its development plan is attempting to raise the economic standing of the country's native population (the Bumiputra) relative to the Chinese, Indian and other immigrant communities who have dominated Malaysian economic activity for many decades. In any event, the perception of such constraints, whether justified or not, will almost certainly mean that taxation is not the limiting factor on the growth of the firm.

Financing Decisions and Profit Distribution

Perceptions of business managers regarding the influence of tax considerations in financing and distribution decisions are summarised in Table 6D.

Table 6D

Relevance of Tax Considerations in Financing and Profit Distribution Decisions

Country.	SL	Malaysia	The Philippines
Taxation is a relevant consideration in		In Number of firms	
(a) Borrowing Policy decisions	16	5	3
(b) Profit Distribution decisions	44	8	4
		As %age of Total in Sample	
(a) Borrowing Policy decisions	23%	29%	43%
(b) Profit Distribution decisions	59%	44%	57%

The responses in the Malaysian and Philippine samples correspond to those in SL in that in all countries the relevance of tax considerations is higher in respect of profit distributions than for borrowing policy decisions.

Though the small sample size precludes statistically significant conclusions, the Philippine sample was seen to display a number of characteristics relating to financing decisions which set it apart from the other two samples. Firstly, the gearing level of Philippine firms was the highest among the three groups (Appendix 11.10); secondly taxation was a consideration in the borrowing policy decisions of proportionately more Philippine firms than among firms from the other two countries (Table 6D).

Furthermore, all Philippine firms who took taxation into consideration in their financing decisions were in the highest gearing category. No relationship was seen however in the SL and Malaysian samples between the relevance of tax considerations in financing decisions and the level of gearing (Appendix 11.11). Also, it was seen earlier (in Table 6C) that shortage of finance was a more common constraint for Philippine business than for firms in the other two countries.

Viewed together these differences suggest that perceptions and practices of Philippine businessmen in the financing of their firms differ from those of their SL and Malaysian counterparts. As far as can be ascertained, the financial institutions and markets in the Philippines are better developed than in SL and at least as well developed as in Malaysia.(8)(154) Nor is there any material difference between the Philippines and the other two countries in the law relating to tax deductability of interest payments.(154)(208) The indications then are that the differences observed in the survey reflect variations in financing practices rather than differences in the tax or institutional environment. Further investigations would, however, be necessary before firm conclusions can be reached.

Though taxation is more relevant in the distribution of profits than in financing decisions for all country samples (Table 6D), it can be seen (in Appendix 11.12) that the degree of relevance is lower in Malaysia than in SL or the Philippines. However, the statistical significance of this observation is low (χ^2 significant at 0.25) and it must therefore be treated as tentative.

Nevertheless it is possible to speculate that the somewhat lower relevance of tax considerations in Malaysia reflects the fact that no tax cash flows arise on payment of dividends in that country. There is no withholding tax on dividends in Malaysia whereas dividend taxes of $33\frac{1}{3}$%

and 35% are payable in SL and the Philippines respectively. In all three countries, however, dividends are liable to tax in the hands of shareholders (except in the cases where special tax holidays apply), and from a combined company-cum-shareholder point of view the absence of a withholding tax makes no difference to the ultimate amount paid in tax on dividend income. Double taxation of distributed corporate profits is a part of the tax law in all three countries, but there will be no tax cash flows associated with dividends in Malaysia.

Conclusion

Given the small sample size in Malaysia and the Philippines and as no interviews were possible in these countries to clarify answers to the postal questionnaire, it is not possible to draw many strong conclusions from the results discussed in this chapter. The postal questionnaires completed by professional observers in Malaysia and the Philippines (9 in each country) have not been discussed separately, but the responses of the professional observers (summarised in Appendix 11.13) are broadly in agreement with those of business managers.

Subject to these generalisations some similarities have been observed among the country samples in business perceptions of taxation. The views are fairly similar in the three countries in regard to the influence of taxation on the achievement of business objectives and on the relative importance of tax considerations in decisions relating to financing and profit distributions.

At the same time many differences were observed between countries. In relation to taxation, the main difference is seen in the appreciation of tax incentives, with SL business favouring accelerated capital allowances

while Malaysian and Philippine respondents were more appreciative of tax holidays. The underlying causes for this difference seem to lie within the tax systems; in the variations of the magnitude of benefits offered via each type of incentive.

Many differences were also observed in organisational characteristics and achievement among the country samples. For instance the sort of constraints on SL business differed from those restricting the activities of Malaysian and Philippine firms. Dissimilarities were also observed in the achievement of growth both in total and according to management type between countries.

Perhaps the main conclusion emerging from the foregoing analysis is however that it is not possible to generalise for all countries on the basis of results of a study of one country into the characteristics of business firms or the impact of environmental constraints on business performance. Taxation does not exist in a vacuum, but its impact on business decisions will be felt alongside those of other socio-economic variables from the environment in which a business firm operates. If organisational characteristics of firms tend to differ between countries and if non-tax environmental influences are also different (both phenomena were observed in this chapter), then generalisations on the impact of taxation across countries are unlikely to be wholly tenable. Nevertheless, the results of Malaysian and Philippine surveys analysed above support the conclusions arrived at on the SL survey that taxation, though perceived as a constraint by many business managers, is unlikely to be a limiting factor on business activity primarily because other greater environmental constraints are present.

CHAPTER 7

Response of Multinational Corporations to Taxation in LDCs - An Enquiry

Foreign private investment is of sizeable magnitude today in most LDCs outside the communist world. Many of these countries indeed vie with one another to attract foreign investment. As discussed in Chapter 1 tax incentives are a device commonly used in this race to draw foreign capital investment. The welcome to foreign investors is however not unconditional and many restrictions on their activities are concurrently imposed by most developing countries.

The last four chapters discussed attitudes to taxation of business management in LDCs. Some of the survey data used in that discussion related to LDC subsidiaries of western multinational companies (MNCs), but in each case the questionnaire was completed and the interview was granted by the management of the local subsidiary. Their experience in most cases and their perspective, as indeed the questions asked of them, related to the local situation: their replies, therefore, are not expected necessarily to reflect parent company attitudes and perceptions in regard to the developing world in general.

Most if not all of the local subsidiaries were founded some number of years ago, when corporate perceptions of taxation (even in developed countries) were less sophisticated, and when the foreign investment decisions by MNCs were taking place in political and economic environments significantly different from those of today. It does not at all follow that, because a MNC has a subsidiary or close associate in a certain LDC now, it would even wish (much less necessarily be permitted) to establish such an investment *de novo* in the hypothetical absence of that subsidiary. Even the continuation of operations of an existing subsidiary might well reflect world-wide 'public

relations' considerations or the desire to avoid book losses associated with an abandonment decision, rather than the existence of an economically worth-while venture now or in the foreseeable future. The current attitude of MNCs to individual developing countries (or to third world investments in general) will be formed in the light of comparative current and expected future conditions and opportunities in all parts of the world. Therefore, a study of the effects of LDC taxation on MNC decisions must include an examination of relevant attitudes of the parent company as well as those of local management.

This chapter seeks to answer the questions:

(a) is taxation, particularly host country taxation (including tax incentives) a significant decision variable in MNC decisions to invest in developing countries?;

(b) what are the important factors discouraging or constraining MNC activity in these countries?; and

(c) how important a consideration is taxation in operating decisions such as financing and pricing decisions of MNCs in the third world?

Western multinationals are not the only source of private foreign investment in the LDCs. There have at all times in history been some private investment by LDC investors in other LDCs and an increase in such investment has been reported in recent years.[115] More recently, Japanese multinationals have been showing an increasing interest in LDC investments.[185] Nevertheless, western multinationals are perhaps the single most important source of private investment funds and technology to LDCs and it is the intention here to discuss their attitudes and perceptions.

Methods

The method of enquiry adopted is again a survey. A survey was carried

out in 1976/77 of a sample of UK and US multinational companies operating in LDCs.

The sample comprised,

1. all UK and US multinational companies known to have been operating in SL in recent years, and

2. a random sample of UK and US MNCs listed in the directory 'Who Owns Whom?'[195] as operating in Malaysia or the Philippines.

A short questionnaire (reproduced in appendix 12) was addressed to the Finance Directors of 57 UK companies and 64 US companies selected as above. Subsequently seven of the UK multinationals were interviewed and seven including most of those interviewed completed a further questionnaire relating to their activities in LDCs. Relevant remarks of interviewees will be quoted extensively in this chapter.

The questions posed to MNC managers probably touched upon some of the more 'sensitive' policy variables of corporate decision-making. The enquiry which is reported in this chapter was remarkable for the willingness of major corporate executives to discuss them, with an openness which was even more appreciated than it was unexpected. Even so, a substantial degree of discretion was plainly called for: and within the time constraints and with the resources available, of necessity only a limited exploration of these important questions could be undertaken.

Response

Statistics of responses to the main questionnaire are summarised in Table 7A.

Table 7A

Statistics of Survey Responses

	UK	USA
Questionnaires despatched	57	64
Responses received	32	19
Responses received expressed as percentage of questionnaires despatched	56%	30%

Of the 32 UK companies replying, one company claimed not to have any investments in developing countries. The responses to the main questionnaire analysed below therefore relate to 31 UK companies and 19 US companies totalling 50 in all.

Analysis of Responses

Tax consideration in LDC investment

The respondents were asked whether in their experience they had found taxation in the host country to be a significant consideration in deciding to invest in developing countries. The answers are summarised in Table 7B.

Table 7B

Relevance of Tax Considerations in LDC investment Decisions

Taxation in the host country is a significant consideration.

	UK Companies	US Companies	Total	As %age of Total
Always	11	6	17	34
Often	3	4	7	14
Sometimes	11	4	15	30
Seldom	5	5	10	20
Never	1	-	1	2
			50	100

From the data in Table 7B it can be observed that:

(a) there is considerable variation of experience among respondents as to the relevance of LDC taxation in investment decisions, but

(b) there is no apparent difference between the distribution of responses of UK firms and US firms.

This response raises a further question: why is there such a wide spread of experience among MNCs in regard to LDC taxes? More than 20% of the respondents seldom or never find taxation to be a significant factor while a third of the sample always do. Subsequent interviews with some of the UK respondents suggested several possible explanations: these are discussed below.

LDC taxation can be perceived as being non-significant if the company practice is to exclude taxation considerations from its investment appraisal processes. For instance, investment decisions may be based on criteria other than profitability or on pre-tax profitability. This however is a possibility that can be eliminated with some confidence (a) as all seven companies completing the second questionnaire replied that they did carry out appraisals of economic viability of investment proposals and that they included host country taxations in such appraisals and (b) as all respondents were large MNCs which can be expected to have the expertise necessary to evaluate the impact of taxation on investment decisions. Therefore it is not unreasonable to assume that where taxation is said to be seldom or never a significant consideration, the view reflects the lack of significance of taxation variables in the decision process and not the company's failure to consider the impact of taxation.

Statements made by MNC officers interviewed subsequently also support the notion that taxation is taken into account in investment appraisal as a factor affecting investment returns. For instance;

> "What is important about taxation is whether as a factor it helps to inhibit a proper D.C.F. return: the high tax rate may be compensated by tax holidays or accelerated depreciation, etc."

It may however not be possible for a head-office manager of an MNC to clearly perceive or comment on the significance of LDC taxation if tax is

just one of many inputs to the computation of investment returns and the significance of the tax factor is not separately tested and reported. According to one interviewee,

> "It is difficult to describe (the part played by taxation in economic analysis) because the advantages of using a computerised corporate financial model are such that you can afford to in effect give equal priority to all aspects; because you do cover every single one."

This statement is remarkable in that the use of a computerised corporate financial model would normally be expected to facilitate the asking of 'what if' questions in order to ascertain the sensitivity of corporate performance to changes in major input variables including taxation. It does, however, imply that in the experience of this company, taxation has been a relatively stable environmental variable with the result that project sensitivity to variations in taxation are not normally reported to top management.

The one UK company which asserted that taxation was never a significant consideration is a manufacturer of specialised equipment largely for industrial and commercial use. They face no competition in most countries where they have established themselves and their investments in LDC manufacturing operations have been made mainly for the purpose of retaining local markets threatened by government restrictions of one sort or another. Because they deal in a specialised industrial product and not mass consumption items they are unaffected by price controls and find that in markets with little competition and no price controls, they can operate at a profit whatever the taxes. In their case,

> "... the main inhibition against capital investment in any of these countries (LDCs) is the demand for the product... You've got very high taxation in India; it works

> out on your accounts (declared profits as opposed to the tax computation) at about very nearly 80% of the profits before tax. But because of that, profit before tax tends to be very high so that when you look at your net returns on capital employed it's not so very far wrong."

In other words this company's experience in the LDCs is that taxation whatever its level can be shifted and hence is not a significant consideration.

The only company interviewed which was primarily a finance company rather than a manufacturing organisation said:

> "Tax in a host country is not a reason for going into a country: but it can very well be the reason for not going into a country."

In contrast with other interviewees they see themselves as having a greater degree of flexibility in choosing locations for and methods of investment. Nevertheless, favourable tax conditions alone would not attract this company to any country.

To the majority of interviewees taxation in the LDCs was only a secondary consideration in making investment decisions. For example,

> "Taxes certainly would be a consideration, but not a main consideration."

> "We don't go in and say it's got a tax situation that makes everything alright. Taxation comes along the line."

> "You don't do things for tax reasons: you get the tax right. You cut the tax coat to fit the person."

> "... Providing we have gone into a situation that looks like there is progress ... we are going to get a fairly good deal on the taxation side."

Above we see several points of view regarding the significance of taxation considerations. Most interviewees find taxation to be a relevant consideration in their decisions relating to LDCs: but none of them regards taxation in LDCs as a primary influence on investment decisions.

In order to ascertain whether or not taxation is a significant constraint on MNC operations in LDCs, we need to look at taxation in relation to other problem areas faced by business. For this purpose respondents to the main questionnaire were asked three further questions:

- the first designed to ascertain what host country-related problems troubled the multinationals investing in LDCs,
- the next to measure the sensitivity of respondents to these problems, and
- the third to rank other problems relative to the difficulties caused by taxation.

Common Problems in LDCs

Eight problems associated with LDC investments (representing the synthesis of theoretical expectations and prior informal discussions with three multinational managers) were listed in the questionnaire and respondents were requested to indicate if in their experience they had found each of these to be relevant (a) in a number of countries, (b) in two or three countries or (c) rarely or never.

The responses where the problems were relevant in two or more countries have been summarised and ranked in Table 7C. In attaching scores to these responses a weight of 3 has been given to problems relevant in a number of countries, a weight of 1 to problems relevant in two or three countries and a weight of zero to problems which are relevant rarely or never. Many respondents added further constraints to the list in the questionnaire and these are listed separately in Table 7C.

Table 7C

Environmental Constraints on Multinational Activity in LDCs

Constraints Listed in Questionnaire	Score*			Ranking		
	UK	USA	Total	UK	USA	Total
Political Uncertainty	80	45	125	1	1	1
Currency exchange controls	73	39	112	2	2	2
Administrative red-tape in obtaining approval.	65	38	103	3	3	3
Import Controls	58	34	92	5	4	4
Scarcity of technical and Managerial skills	60	27	87	4	7	5
Threat of nationalisation	43	32	75	6	6	6
Inadequacy of commerical & financial services	28	33	61	7	5	7
Difficult labour relations	23	24	47	8	8	8
Items added by respondents						
Pressure to increase local ownership	10					
Home country regulations	9					
Price controls	7					
Different ethical and moral standards	3	3				
Prohibitive demands by host govts.	3					
Export requirements	3					
Restriction on borrowing	3					
Hostility to foreign investment	3					
Poor management of host economies	3					
Personal safety of expatriate staff	3					
Uncertainty on validity of regulations		3				
Restrictions on land ownership	1					
Language/mentality	1					
Venal officials	1					

* Score = [No. of firms for whom problem is relevant in a number of countries × 3] + [No. of firms for whom problem is relevant in two or three countries]

The most common constraint faced in the third world by both UK and US multinational companies is political uncertainty, followed by currency exchange controls and administrative red-tape in obtaining approval for their activities. The importance of political stability in the host country has been established for Singapore by Koh[111] and for a group of South American LDCs by Stevens.[221]

Import controls which were the most common problem in the SL local survey are found only in fourth place in Table 7C. Further down the list is found the only major difference in ranking between the UK and US samples: scarcity of technical and managerial skills in LDCs was a more common problem for UK companies than for American firms. As no US firms were interviewed the reason for this difference has not been ascertained: interviewees in the UK however indicated that the difficulties of shortages of skills are exacerbated by host country requirements to transfer local management to nationals of the country.

It is always a possibility with this type of question that responses are conditioned by the suggestions made in the questionnaire itself and that other equally or more common problems not included in the questionnaire will not be commented upon by respondents. This question however provided for respondents to add any other problems they were faced with and twenty items were added to the list. Interviewees at the subsequent interviews were invited to comment on items added by other respondents and their remarks indicate that none of the new items added to the list were more important than the three or four leading items from the list in the questionnaire.

Statements of respondents at the interviews, confirmed the questionnaire results that the stability of the political climate is seen by most MNCs as the primary non-commercial environmental criterion relevant in making a

decision to enter into a new LDC investment. If the political climate is favourable and stable, then it is believed that other conditions cannot be too burdensome. For instance, the following remark,

> "The economics you can work out almost on the back of an envelope. But it's the political future and stability that one is concerned about."

Though political instability may deter an MNC from investing in an LDC, once the first investment is undertaken, and a commitment is made to a particular country, MNCs appear to be willing to take a fairly long-term view and to deal with political instability and other constraints as best they can. For example:

> "One day the conditions in Ghana will improve: it won't be in my lifetime but then we'll be there."

> "We don't look short-term. Even now we are re-investing in certain of our countries where we haven't got dividends out ... you look 10 or 20 years ahead in our business."

The only exception to this rule among the interviewee firms was the finance company referred to earlier which took an extremely short term view of their interests in LDCs. To them,

> "What happens in 20 years is irrelevant: what happens next year or the year after or in three years time is absolutely critical to the vast majority of projects."

The common practice of multinationals in using long planning horizons must further enhance the problems of political uncertainty. In some LDCs where they operate, their planning horizons will be as long as, or longer than, the independent history of the nation state. In the newly independent,

often newly created states where both political and other institutions are being formed anew or shaped to suit the aspirations of the new state and its citizens, cycles of political and institutional change are likely to be shorter than the planning horizons of MNCs. This would necessarily lead to uncertainty about the political environment being a major worry for the companies.

By contrast, political uncertainty did not appear as troublesome to local businessmen in the three LDCs discussed earlier. Even the managers of LDC operations of MNCs participating in the earlier local surveys were most concerned about problems of import controls and market limitations. Political uncertainty was however mentioned as a constraint by several professional observers in the LDCs.

One possible explanation for the difference in sensitivity to political uncertainties is that LDC business managers on the spot who are exposed to the political environment of only one country do not see changes in the environmental conditions originating from government sources as a consequence of the overall political climate or instability, but more as specific constraints such as import controls hampering activities of the company. Therefore, any uncertainties relating to the future existence or levels of these controls or levies are also likely to be seen as problems stemming from the specific regulation in question. On the other hand, observers in MNC head offices looking at environmental constraints globally, appear to attribute these same uncertainties to political causes.

Governmental administrative regulations and procedures are also a common irritant to most MNCs. As illustrated by the following remarks, these are found to apply not only in obtaining approval but in relation to all contact with government agencies including the inland revenue authorities. The cause of irritation lies in official indecision as well as in the complexity of the procedures. For example:

"Price control has been itemised separately; but an element of this is red-tape; as it would appear that procedural delays are often an intended part of the control of prices."

"Red-tape is usually more annoying (in the LDCs) because one is in more of a hurry when one is overseas."

"... slowness in settlement (of taxes) can be worse, especially if it is accompanied by demands for tax payments as the cash flow arises and before profits can be computed."

"Indecision among tax authorities is a major problem. Often you can argue for days with local tax men without obtaining a decision : and then you see a white face, you tell him your problem, and a decision is made then and there."

Similar results have been reported by Reuber.(219,p.115)

Another group of difficulties added to the list arose from cultural differences between the LDCs concerned and the MNC home country, and were described variously as problems of language, mentality, different ethical and moral standards,etc. Some of the difficulties cited as examples of red-tape were also capable of being classified under cultural differences. This is however a problem area peculiar to MNCs that has long been recognised in the literature on management. According to Lawrence and Lorsch, a multinational company has

"not only to span the necessary differences among functional and product specialists, but also to

bridge unavoidable differences among cultures."[218,p.230]

The impression gained at the interviews was that the older, more established MNCs appeared to be less worried by these problems, suggesting that this is a class of difficulty which is reduced in significance with time and familiarity and with the building up of close business relationships with individuals or organisations in the host countries.

It was evident from statements made at the interviews that not all companies operating in the MNCs had similar objectives and therefore not all environmental constraints were commonly experienced. For instance, restrictions on local borrowing imposed by host governments were a problem to some of the interviewees, but not to others. One company which specialised in providing minority finance for foreign investment, in fact, found this requirement to work to their advantage. Similarly, regulations imposed by host governments requiring a minimum level of participation in the investment by local capital was a problem to a number of firms: but one MNC said that in their case local participation was desirable for commercial reasons and was actively sought by the group.

Many of the items added to the list of constraints by respondents reflect special characteristics of their organisation or operations. For instance, an MNC operating in a large scale extractive industry said that they found prohibitive demands by host governments to be the problem and that they looked at and sometimes found the 'whole package' to be unacceptable. This attitude probably reflects the fact that their kind of operations for the exploitation of natural resources in host countries are often so large and so important to the countries in question that special packages of regulations and levies are put together for them.

Another company in the clothing industry found export requirements of LDC governments to be a problem. This type of company is often allowed access to cheap labour in LDCs and offered free trade facilities provided all or the

bulk of output is exported. Export requirements can, under these conditions, appear to be a major constraint; particularly if there is considerable untapped demand within the country of manufacture. The majority of MNCs whose investments in LDCs were generally meant to satisfy local demand did not face this difficulty.

Harshness of Constraints

The next question in the main questionnaire required respondents to name the one or two problems causing them the most difficulty in the LDCs (as opposed to the most common problems discussed in the previous section). The responses are summarised in Table 7D.

Table 7D

Ranking of environmental problems causing the most difficulty in LDCs

Constraint	Score*			Ranking		
	UK	US	Total	UK	US	Total
Political uncertainty	11	12	23	2	1	1
Exchange controls	15	7	22	1	2	2
Scarcity of skills	9	2	11	3	4eq.	3
Administrative red-tape	8	2	10	4	4eq.	4
Threat of nationalisation	3	3	6	6	3	5eq.
Import controls	5	1	6	5	8	5eq.
Difficult labour relations		2	2		4eq.	7eq.
Inadequate services		2	2		4eq.	7eq.

* Score = Number of times listed as the most difficult or one of two most difficult problems.

It can be seen in Table 7D, that the two most common problems, viz. political uncertainty and currency exchange control, also cause the most difficulty. Both UK and US multinationals rank these two problems at the

top of their list a considerable distance above other problems. There are minor differences between Tables 7C and 7D in the ranking of problems at the lower end, but the scores on these are well below those of the top two.

Taxation v other constraints

A separate multiple answer question seeking a ranking of the other main constraints with reference to the problems of taxation in LDCs gave a somewhat different ranking to that in the previous question: but also provided overwhelming evidence of the unimportance of taxation as a constraint facing foreign investors in LDCs. Respondents were required to state whether taxation was (a) a more important problem, (b) an equally important problem or (c) a less important problem than each of the other constraints listed in the questionnaire. The responses are summarised in Table 7E.

Table 7E

Ranking of LDC related environmental problems with reference to Tax Constraints

	Score*			Ranking		
	UK	US	Total	UK	US	Total
Political Uncertainty	17	11	28	1	1	1
Threat of Nationalisation	10	8	18	3	4eq.	2
Exchange Controls	14	3	17	2	8	3
Scarcity of skills	6	10	16	5	2	4
Import controls	7	8	15	4	4eq.	5
Labour relations	5	9	14	6	3	6
Administrative red-tape	4	4	8	7	6eq.	7
Inadequate services	-3	4	1	9	6eq.	8
Taxation	0	0	0	8	9	9

* Score
1. Taxation or Problem equally important as taxation = 0
2. Problem more important than taxation = 1
3. Problem less important than taxation =-1

In the ranking in Table 7E taxation appears at the bottom of the list overall and in the US sample. Among UK firms tax problems edge their way to a position just above problems of inadequate services. In a previous section we reported that there was a wide divergence of opinion among MNCs as to the significance of taxation considerations in LDC investment decisions. The results here suggest that even where taxation is a significant consideration, in most cases it is unlikely to be a major constraint.

For MNC investors LDC taxes are not a big problem. In contrast, in each of the LDC business surveys (though the ranking was obtained on the basis of answers to slightly different questions) taxation was a common problem perceived as a constraint on the achievement of business objectives by the majority of respondents. In the SL survey tax problems ranked second only to import controls in the list of constraints on business. In the Philippine and Malaysian surveys too tax constraints ranked second but this time below market limitations which headed their list of problems.

Reasons for low sensitivity of MNCs to LDC tax constraints

The interviews with UK MNCs suggested several possible explanations for the low level of sensitivity among MNCs to LDC taxation problems. The main reason appears to be the presence of fairly high taxation at home. In the case of UK multinationals only profits remitted back to the UK as dividends from foreign subsidiaries are subject to UK tax. Against the UK tax however is allowed the deduction of all underlying tax paid abroad on the dividends received. Therefore the presence of overseas taxation will have no effect on the parent company's tax bill unless the average of all overseas tax rates paid on profits remitted exceeded the effective tax rate in the UK. Companies can, however, find themselves paying higher taxes because of the UK rules for relieving Advance Corporation Tax. (Appendix 13 explains the UK tax law relating to overseas earnings of MNCs.) For instance,

> "In our case taxation abroad is not a problem because UK taxation has always been high. In most of the countries we have been trading tax rates haven't been any higher than in the UK: with the exception of two or three countries where the level of profit is high. Then the level of taxation wouldn't worry us."

The view that taxes in LDCs are not a burden because profit levels were high in these countries was shared by other companies. One of these said,

> "The returns in developing countries can also be higher than in some of the developed countries; certainly higher than in the UK in terms of return on assets."

A company that had no UK income against which relief on ACT could be claimed provided the only instance where overseas taxation was a burden.

> "Overseas taxation is much more of a worry than UK taxes because of the extent to which you can get relief. We are however a special case because we make more money overseas. We could get tax relief, on our UK taxes, if we had some but we haven't any."

It is, of course, possible that overseas taxes may have become a more common problem for UK multinationals since then. With the growth of overseas operations and losses in UK activities becoming more common, overseas taxes may come to be more important to many more MNCs.

Another factor which may explain why overseas taxes are not a great problem to MNCs, is that these companies are in a position, within limits,

to shift profits between countries via appropriate transfer prices in order to minimise taxes globally. One company said of high LDC taxes:

> "... obviously we would then seek to maintain our returns in some way and if the tax rate is high it would presumably have to be through a consultancy or technical service fee."

One MNC in a highly capital intensive industry explained that in their case high depreciation charges in the accounts meant that they have a generous cash flow cushion protecting them against adverse short-term fluctuations in taxation.

> "... the tendency is to say that being a capital intensive industry we also have a fairly good cash flow (we have high depreciation on the whole) and therefore we are not hit very hard, very quickly with any changes in turnover, inflation or taxation. We tend to rely on muddling through until the companies that are more exposed than we are collectively persuade the government to change their taxation policy, until there is a change of taxation policy for any other reason or in some cases where we ourselves can manage to get a decision changed. Because we have this time lag before it hits us hard, I think on the whole we would sit it out."

A variety of reasons, then, were given as to why LDC taxes were not a major problem relative to other constrainst facing MNCs in these countries. The reasons differ from firm to firm but there is more or less general agreement that taxation ranks very low among constraints on Multinational business operating in the LDCs.

Sensitivity to Tax Constraints and Management Type

In the previous chapter it was reported that owner-managers in the three LDCs under discussion were more sensitive than professional managers to the problems of taxation. Among MNC managers we see a much lower level of sensitivity to taxation as a problem than among either type of manager in the LDCs. It must be acknowledged that the tax environment facing MNC managers is somewhat different to that experienced by LDC managers operating within one country. Nevertheless, these results raise the possibility that the level of sensitivity among business managers to problems of taxation is reduced with increasing professionalism of management or the increasing complexity of the organisation structure.

Organisation theory acknowledges that complex organisations set up boundary-spanning activities to buffer the rest of the organisation from uncertainties originating from the task environment.[183,Ch.6] The presence of specialist professionals dealing with tax problems and uncertainties and opportunities created by taxation can accordingly be expected to reduce the sensitivity of general management to tax constraints. It would therefore not be unreasonable to suggest that differences in the structure of organisational management can contribute to the variations observed in the sensitivity of business managers to tax problems.

The rest of the chapter examines the impact of LDC taxation on a number of specific decision areas.

LDC Taxes and Investment Decisions of Multinational Corporations

This section examines MNC investment decision processes and the effect of taxation on their decisions.

The decision processes relating to investment are to some extent determined by the objectives of MNCs in making LDC investments. Interviewee

comments indicate that generally, the prime reason for investments in a third world country is the gaining or retaining of access to a market. There were exceptions however: e.g. in one company in the extraction industry, the rationale for going into any country was to gain access to its mineral resources, and another apparently used LDCs as bases for manufacturing for export. To the majority,

> "The main consideration in making an overseas investment decision is the market."
>
> "It's in the nature of an international company that it wishes to be where it can sell its product..."
>
> "We want representation of the company there (in LDC markets). We can do this by exporting, by having a franchise or by having a subsidiary or even an associate company."

These results are in accordance with the findings of Nayyar that access to markets was the main reason for the presence of MNC manufacturing establishments in LDCs, though manufacturing for export has become an increasingly important function in recent years.(133)

It is however necessary to make two qualifications to the above analysis. Firstly, though the main reason for going into a foreign country is its market, the main decision criteria relate to economic viability, viz., profitability and cash flow. For example:

> "When assessing a project from our point of view, first of all we want to establish its economic viability: but whether or not we invest, to a large extent, is a matter of the revenue that we see: not our earnings proportions but our dividends received."

Secondly, though the views discussed above related to new or 'greenfield'

investments in LDCs, some of the MNC investment in these areas will involve the reinvestment of retained earnings.[219,p.72] Such investments can very well be influenced by factors other than market considerations. For example; local controls such as exchange controls on remittance of earnings may force a MNC to reinvest part of their earnings in the host country, or then again, tax avoidance objectives may lead to 'turntable' investments in host countries directly or via suitable tax havens.[44,p.12]

Seven of the UK respondents to the main questionnaire agreed to complete a further questionnaire dealing with the manner in which tax considerations entered into their investment decision processes. Their responses are summarised in Appendix 14.

Of the seven firms, five firms used DCF techniques to evaluate investment proposals. Two of the above used the payback technique alongside DCF calculations. Of the two remaining firms, one used the payback technique and the other, Return on capital employed.

Taxation in the host country was said to be taken into account in the computations of the performance measure in every case, though rough and ready calculations at the initial stages of project analysis were done on a pre-tax basis by some of the firms. As discussed previously, the impact of taxation on the performance measures implied in the different techniques will not be the same. However, it is in the very nature of all the above investment evaluation techniques that the performance of an investment project is expressed as a single numerical figure to be compared with a pre-determined required level of performance. For instance, the DCF techniques would require a given minimum Internal Rate of Return or a positive Net Present Value at a pre-determined cost of capital. None of the project cash flows (including tax cash flows) forming input data for the calculation of Internal Rate of Return or Net Present Value would be visible in the final

results of the DCF computations. It is therefore unlikely that the investment decision-makers (who will not necessarily be the technical personnel carrying out the calculations) will actually perceive the impact of taxation on project returns unless they had been advised of the hypothetical project returns before taxes as well as the post-tax returns, and/or the results of sensitivity tests on hypothetical variations in taxation.

If the computation of project returns is carried out at the offices of the host country branch or subsidiary, then the detailed input data are even further removed from the head-office or parent company decision-makers. Among respondent firms, calculations for and appraisal of proposals for expansion or replacement investment are done jointly by group head-office and local office. Some of these firms explained at later interviews that the usual procedure for this type of investment was for subsidiaries to carry out all necessary computations locally, with review and approval at head office for major investments or when additional funds were requested from the parent company.

In three of the seven firms, local host country offices were said to be involved in the appraisal of the initial investment proposal as well. The apparent inconsistency regarding the involvement of host country officers in making the initial investment in a foreign country is resolved when one considers the usual steps in the investment process where most MNCs tend to look for access to an LDC market via exports before making an investment in manufacturing facilities. When an investment is considered, therefore, they would already have a branch office or an agent representing them locally in the foreign country.

There is little doubt that LDC taxes enter as a relevant variable into

the investment appraisals of MNCs. (All seven companies contributing to the data included host country taxes in their appraisals.) But at the same time, as illustrated by a remark quoted earlier in this chapter, it may be difficult for the decision-maker to assess the impact of taxation on the investment because many other relevant factors are also encompassed in the performance measure on which the investment decision is largely based.

All but one of the seven firms said that they included host country income - and remittance - based taxes as well as home country income-based taxes in their investment appraisals. This suggests that a predetermined profit distribution and dividend remittance policy is built into the cash and income flows used in the appraisals. Whether or not these estimates are adhered to in practice is, however, not known.

In discussing the impact of corporate taxation on the decisions of MNCs to invest in developing countries, it would be possible to compare tax structures of different countries, in order to rank countries according to tax burdens or benefits, only if all other environmental influences were equal. But the remarks of survey firms indicate that MNCs themselves (except in occasional and essentially theoretical exercises) do not approach international investment decisions in this way.

> "You can compare these (taxes in different countries) only if everything else were equal; which they are not."

One instance where the impact of taxation is relevant, and needs to be separately calculated and reported, is when a change in the tax burden in any given country could affect the outcome of a proposed investment. Although all MNCs interviewed were of the opinion that there was much uncertainty attached to the future tax burden on LDC investments, only one

of the seven firms contributing to the data in Appendix 14 regularly in their investment appraisals took into account the possibility of future changes in the tax structures. This firm, however, did no more than consider all possibilities in arriving at single figure 'best estimates' for tax flows. One other firm which did not regularly allow for uncertainty relating to taxation in their investment appraisals used sensitivity analysis to test the effect on project DCF returns of specific changes in the tax structure

> "where the change is virtually certain."

The other companies all do their evaluations on the basis of the tax structure at the time of appraisal.

> "You look at taxation as it stands at the moment you are working on the project. You cannot normally predict how it will change. You work the whole thing out on the system as it stands now and trust to luck that it does not alter to such an extent that it alters dramatically the result of what you are doing."

> "Tax considerations are usually less worrying, one because they are changing all the time."

The very changeability of tax burdens apparently triggers the response in the decision-makers to ignore the uncertainty ... Small changes in the tax rate or burden are expected to occur regularly but because of the high level of uncertainty involved, the MNC decision-makers choose to overlook the fact. This view is supported by the findings of Schall and Sundem(157) that,

> "Firms in less certain environments tend to use less sophisticated capital budgeting methods."

It is probably the experience of the MNCs that ordinarily, although

there are many frequent changes in tax rates and structures in most countries, the overall effect on the total tax burden is not very large or significant in the short term. As one interviewee said,

> "Changes in tax structures are frequent:
> the rates go up about 5% every now and again."

Excluding major changes in the tax structure which are a part of a change in the total investment environment precipitated by a major political upheaval, in the main what is true of tax systems the world over is that the changes in the law are frequent but that any increase in the burden of taxation occurs by a slow process of creeping up over many years rather than by single sudden leaps.

The fact the MNCs tend to ignore uncertainties of taxation and that they do not find taxation to be a major problem does not, however, mean they will not take steps wherever possible to minimise taxation. The investment in an LDC may itself not be undertaken for tax reasons, but all the firms have procedures for the arrangement of their investments in such a way as to minimise taxes within the group's overall aims and preferences. However, again this seems not be an overwhelming consideration. For instance, one interviewee said,

> "..., one of our directors, ... is quite a
> great expert on tax. If they say don't do
> it quite like that, do it this-a-ways, then
> we do it. But if we say, if we do it that-a-ways
> its going to create stresses or management problems,
> they say well, okay, forget it."

The interviewees were unanimous in their opinion that they found tax incentives offered by LDCs to be useful and that these could (through their impact on investment returns), influence investment decisions. Nevertheless,

they were emphatic that normally, no investment decision would be made purely for tax advantages.

> "Tax incentives will be unlikely to alter a major decision on their own because these things can change."

> "I don't think tax holidays affect the primary decision that you go and invest money. It's quite likely to affect how you do it."

> "We would take advantage of tax incentives, but they wouldn't tip the scale."

Another device often used by LDCs to encourage investment by private foreign capital, viz. double tax relief (DTR) agreements received a mixed response. Some interviewee companies saw no great benefit accruing to them from DTR agreements between the UK and LDCs, because of the system of unilateral relief which operated in the UK in any case.

> "Double tax relief agreements are not very significant."

> "A double tax agreement would normally determine the share of revenue between governments. Our profits would receive relief from UK tax even without a double tax agreement."

Several others, however, perceived DTR agreements differently,

> "Double tax relief treaties are important."

> "I think probably the one (tax related variable) that may prompt us to lose interest in any given country is the loss of double taxation relief. The creation of an agreement, the ratification of a treaty for double taxation, would not in itself make us look at

> a country with a view towards investing, but where we have an investment and double taxation relief is withdrawn we could well decide to pull out."

The divergence of opinion probably reflects differences in experience between companies with regard to double taxation relief on the one hand and possibly also to some extent the unfamiliarity of the interviewees with the complex provisions for double taxation relief in the UK. The belief that double tax relief agreements would largely determine the sharing of taxation between governments and that a UK company would in any case receive unilateral relief on its overseas income would have been correct before the UK authorities began introducing "tax-sparing" provisions (see appendix 13) in the middle seventies to their double tax relief agreements. However this statement could still describe the position of an old established multinational which has not in recent years received any major tax exemption or investment incentives in countries with which tax-sparing arrangements have been made by the UK Inland Revenue.

The results discussed so far indicate that taxation is not a major reason for a multinational investing in an LDC. Access to the LDC market, we were told, is the prime consideration. In order to get a better idea of the sort of countries in the third world that interest MNCs, the respondents in the main survey were asked if they had investments in six selected LDCs, including the three countries with reference to which the sample of MNCs were drawn. The replies are summarised in Table 7F.

The US firms were seen to have a far greater interest in the Philippines than the UK MNCs, whereas the UK firms showed a greater presence in the other five, all ex-colonial commonwealth countries.

Table 7F

Investment by Respondent Firms in Selected LDCs

Number of Companies with investment in	UK firms	US firms
Jamaica	10	2
Malaysia	25	5
Nigeria	20	1
The Philippines	10	15
Sri Lanka	15	-
Zambia	12	-
Number of firms in sample	31	19

It is possible that these results reflect to some extent, the methods of sample selection whereby companies known to have investments in SL, Malaysia and the Philippines were selected to receive the questionnaire. Nevertheless, they clearly suggest that MNCs show a greater interest in countries coming under the political influence of their home country, with UK firms in the sample dominating commonwealth countries and the US firms showing a greater presence in the ex-US-colonial possession, the Philippines.

The respondents who had no investments in SL were asked to state reasons for their absence from that country. Nineteen firms supplied reasons and these are summarised in Table 7G.

Table 7G

Reasons for not holding investments in Sri Lanka

	By UK firms	By US firms
The possibility of investing has not been considered	3	8
The possibility of investing was considered but a decision was made against investing	4	2
Investments were held in the past	2	-
	9	10

It can be seen in Table 7G that eight out of the ten US firms had not even considered the possibility of investing in SL whereas five of the nine UK firms had either held investments in SL or had considered the possibility of doing so, sometime in the past. This greater interest in SL by UK firms relative to US firms, even in the group that had no investments in that country (a member of the Commonwealth) supports the proposition made earlier that MNCs show a greater interest in LDCs with which their home country has historical or current political ties.

Comparing the attitude of the MNCs to LDC investments with that relating to developed country locations, the interviewees believed that their attitude would be no different: but several areas of difference often encountered in the two types of country were mentioned. These are listed below.

1. Quality of product is more important in developed countries. Therefore, competition from low-quality low-priced local products is less common than in LDCs;

2. But it is more difficult to break into markets in developed countries.

3. Return on investment tends to be higher in the LDCs.

4. Political factors are more important in the LDCs than in developed countries, whereas commercial considerations tend to be the limiting factors in the developed countries.

In no case did the interviewees think that their response to taxation would be any different between LDCs and developed countries. However, their ability to earn higher returns in LDCs must make multinational corporations generally less concerned about taxation in these areas, compared with developed country locations.

Taxation and Financing Decisions

Most of the companies interviewed had some idea of a finance mix they would like to see in overseas investments, but they all agreed that given the differences between countries - for example in interest rates, exchange control regulations and host government regulations relating to borrowing by foreign firms - each case in each country needed to be looked at separately.

> "Very roughly speaking, I think what we do in Malaysia is probably the ideal. We put up about a quarter of the capital that was needed: we guaranteed to banks for them to lend to the local company a half and we then had a public issue for the other quarter ..."

> "We would follow an order of preference for a subsidiary which is wholly owned, we would first try to get them to borrow locally without any ties with the UK. If that is not possible the second thing we would consider is borrowing locally but with some sort of support from the UK, ... the next is giving that company a loan from the UK - and charge a market rate of interest. We would not borrow internationally for funds to be used by subsidiaries, except where the need arises for a particular currency in which we want to invest."

> "Whether we borrow would depend on the rate of interest and the rate of exchange."

> "... in many of our overseas companies in terms of pure balance sheet analysis we could do with gearing up. This we seek to do wherever we can, but it is not always possible for political reasons."

Six of the interviewees provided clear answers to the questions relating to the influence of taxation on financing decisions. Taxation was acknowledged by all these firms to be a relevant consideration in decisions relating to financing of overseas investment, but it was not thought by three of them to be a decisive factor. Those firms who believed tax considerations influenced financing decisions said:

> "Financing preferences are tax-related. If there is a very high withholding tax we would suffer ... one has got to get a balance."

> "Sometimes there are tax advantages in debt financing because the interest is allowable against tax."

> "Tax advantages of certain types of financing are used."

On the whole, the MNC managers interviewed were more aware than SL managers of the ways in which tax considerations would influence financing decisions.

Taxation and dividend remittances from foreign subsidiaries

On decisions relating to remittances to the UK of profits and dividends, the companies interviewed were at that time restricted by Bank of England requirements that 2/3rds of overseas earnings should be remitted back to the UK. One of the seven companies interviewed, however, saw this regulation not as a restriction but as a requirement that happened to match exactly their group preferences.

Even within these regulations most interviewees attempted to minimise taxes globally by using an appropriate policy for the remittance of overseas earnings. Several strategies for tax minimisation were mentioned. For example:

1. Subsidiary companies may be formed overseas to collect earnings outside the UK. As UK taxation is only payable on dividends received in the country from overseas subsidiaries, the creation of foreign holding companies to collect overseas earnings and to undertake 'turntable' investments is a useful tax-planning device. As one interviewee explained,

   "An overseas subsidiary can serve as a vehicle for holding funds when you don't want to remit them."

2. It is possible for the subsidiary to pay the parent company's share of net income in a form other than dividends, and where the effective tax on dividend income is higher than on other forms of income, this option is often exercised.

   "We are able to choose between different types of income very, very occasionally: the flexibility is not very great. Presumably, tax is the reason why we are doing it."

   "If the tax rate is too high, we would seek to maintain our returns in some other way, ... it would presumably have to be through a consultancy or technical services fee."

3. As UK unilateral DTR provides for the deduction from UK taxes of underlying foreign tax on income received in the UK, it is advantageous for UK MNCs (within limits) to choose to bring into the country income from high-tax countries in preference to income from countries with low tax rates. There is evidence that this practice is adopted by some at least of the interviewees,

   "For instance if you have a tax-free area you don't bring money out of that one because it means paying tax when it comes here, which it has to when one is declaring it as a dividend."

Only one of the seven companies interviewed said that taxation was irrelevant in their policy relating to remittances from overseas subsidiaries and this was because the company followed a policy of requiring a standard minimum percentage of earnings to be remitted unless local restrictions necessitated lower levels of remittance. All others agreed that tax considerations were important in the distribution decision, even though some of them had said that taxation was not very important in financing decisions. Why this should be so when the two types of decision are closely interrelated is not clear; but a similar response was seen in the LDC surveys as well, although the level of importance of tax in distribution decisions of LDC managers was considerably lower.

One possible explanation (though not proven) for the greater relevance of tax considerations in distribution decisions relative to financing decisions may be that the significance of non-tax influences is greater in the latter decision area. If other market or governmental influences are so important as to be limiting factors on the finance mix, tax considerations may be subordinated. If the firm has greater flexibility in regard to profit distributions (and this would be particularly true of dividends of MNC subsidiaries, which are mainly intra-group transfers), then tax considerations and tax minimisation objectives are likely to become more important.

On the whole UK multinational managers show a higher awareness of the relevance of taxation. It must be noted however that the UK law relating to dividend distributions, with payment and recovery of Advance Corporation Tax and the various rules for group taxation and group relief, is far more complex than the laws of the three LDCs studied. The complexity of the law itself could very well increase manager perceptions as to the importance of taxation considerations in distribution and other corporate decisions.

In a previous section it was reported that most multinational companies interviewed seemed to have dividend policy estimates built into their

investment appraisal calculations. The remarks relating to tax effects on distribution remittance policies however indicate that the policy is reviewed regularly and how much is remitted back to the UK from any one source is determined by a number of variables, including profits available from alternative sources, government restrictions, re-investment requirements and UK dividend payments of the parent company. The companies appear to attempt to put together a mix of remittances to meet all the above requirements as well as to minimise the global tax bill and maximise UK double tax relief.

Taxation and Pricing Decisions

The interviewees were also questioned on the relevance of tax considerations in their pricing decisions in the LDCs. Corporation Tax appears to be treated differently from indirect taxes in pricing decisions of the MNC interviewees. This result agrees with the findings of the SL survey on the pricing practices of firms in that country. Views of MNC interviewees discussed in this section relate to the pricing of their products to customers and not to transfer pricing within the group of companies.

All but one of the interviewees argued that they either as a matter of policy or of necessity included all indirect taxes such as customs duties and value added or sales taxes in their costing for pricing purposes, but that income taxes were not a consideration in pricing decisions. For example:

> "We always work on pre-tax profits: but there are other taxes like VAT in the UK and, in some foreign countries, sales tax. Obviously that would be added to the price to the consumer. But you can't always earn the margin that you want because of competitors' activities."

> "Our costing is a landed cost approach ... landed cost plus customs duties. We never take income taxes as a cost. An increase in corporation tax would come off profit. If not you'd price yourself out of the market."

> "Provided we are able to make a profit, corporation tax comes below the line. So presumably there is a slice for the government and a slice for us."

Taken together, these comments imply that the behaviour of MNCs matches the expectations of traditional economic theory in that indirect taxes are shifted by business firms in the short-term while income taxes are not. Cost-plus pricing behaviour as envisaged by Krzyzaniak and Musgrave,(112) wherein income taxes are treated as part of costs, is not the norm in this sample of companies.

It will be recalled, however, that all seven companies completing the second questionnaire stated that they took taxation (including income taxes) into account in their project appraisals. Yet when it comes to pricing decisions they do not seem to (with one exception) pay any attention to the level of income taxes.

Several possible explanatory factors can contribute to this apparent inconsistency in the treatment of income taxes. Firstly, it is possible that the pre-income tax margins that the MNCs seek to achieve or maintain are fixed for each country so as to cover income taxes and therefore in their short-term pricing decisions all that is necessary is to earn the 'required' margin. This possibility is supported by the fact that two interviewees commented in another context that in high-tax LDCs they tend to earn high pre-tax profits, and therefore the high level of taxation in these countries is not a particularly difficult problem. The companies are probably able to price on 'required' margins in the short-term because

income tax rates do not change drastically in the short term within any given country. The indications, however, are that in the long term, tax differentials between countries would be reflected in the required margins and in product prices.

Another possibility is that MNCs operate in third world countries under conditions of either monopoly or perfect markets, and as envisaged in economic theory, are unable to pass on income tax in prices to consumers without moving from a profit maximising position. The presence of import controls and protected markets in many LDCs makes market conditions in these countries highly conducive to monopoly operations.

A third possible factor contributing to the responses received may be the perceptions of social responsibility among MNC managers who may believe that socially responsible companies would not shift increases in income tax to consumers. There is, however, no direct evidence in this survey to suggest that this factor has influenced the survey response.

Functional bias of respondent

This section reports the results of a test carried out separately from the main survey to check on the possibility that the view of taxation obtained in the survey may have been significantly influenced by functional specialisms of the officers answering the questions.

The first questionnaire was addressed to the finance directors of the selected companies but replies in some cases came from officers in the group planning function or officers in charge of LDC operations. The name and designation of the officer replying was not indicated in all responses but as far as can be ascertained from information available none of these came from the firm's tax adviser or the officer directly in charge of tax management. All replies to the second questionnaire and the interviews were similarly with senior officers in general management or the finance function.

The replies, therefore, may with a reasonable degree of confidence be said to represent the views of general and financial management and not that of persons immediately responsible for taxation management.

In order to check the possibility that the analysis of the foregoing sections may be rendered invalid by our inability to introduce a control for the source of response within a firm, a test was carried out in one of the firms responding to the questionnaire whereby seven managers of the same firm were asked to complete the questionnaire independently and on behalf of the firm.

Of the seven respondents from the firm studied, one was the firm's tax manager: the others were all senior managers in charge of overseas investments in different parts of the world. The answers of these respondents to the relevant questions are summarised in Table 7H.

The analyses in Table 7H show

(a) that there were differences between managers as to their perception of taxation and other environmental influences on the activities of the firm in LDCs, but

(b) that the most marked difference was between the tax manager of the firm and the others in relation to questions pertaining to taxation.

The tax manager was the only respondent in this sample to say that taxation was always a consideration and he was also the only person to believe that the problems of taxation were more important than the majority of other difficulties listed in the questionnaire. In his opinion political uncertainty and lack of managerial and technical skills in the LDCs were the only problems more important than taxation.

Table 7H

Sensitivity to Taxation - Tax Manager v other managers

(A) Taxation in the host country is a significant consideration in LDC investment Decisions

	Tax Manager	Other Managers
Always	1	
Often		1
Sometimes		2
Seldom		1
Depends on Country and Time		1
No reply		1
	1	6

(B) Problems of Taxation compared with other Constraints

	Score*
Tax Manager	+4
Investment Manager 1	-1
Investment Manager 2	-4
Investment Manager 3	-5
Investment Manager 4	-7
Investment Manager 5	-8
Investment Manager 6	-8

* Score = Number of problems less important than taxation
- Number of problems more important than taxation.

At a subsequent interview with one of the respondents it was learnt that the familiarity with LDC investment of the other managers varied both in regard to geographical areas covered and the length of experience in dealing with LDC affairs. Despite these differences all the managers other than the tax manager were of opinion that the majority of difficulties listed were more important problems than taxation.

The statistical significance of the above results is necessarily limited by the fact that the data have been collected within a single firm. Nevertheless, the differences observed permit some tentative conclusions.

The differences between the replies of the tax manager and the others viewed as a group may be explained as probably being due to the 'halo-effect' in regard to tax problems on the perceptions of the tax manager whose functional specialism and day to day activities increase in his eyes the importance of tax problems, relative to others.

The differences among the investment managers of the firm may be viewed as providing evidence that the replies to a survey of this nature could indeed be influenced by personalities and experience of the responding officers as well as by their functional or professional specialisms. However, the fact that the differences of opinion in regard to taxation among the non-tax-specialist managers are not as great as the difference between them and the tax specialist can be reasonably interpreted to mean that on the whole the replies from general and financial managers relating to the impact of taxation on MNC activities are not likely to be biased sharply one way or the other.

Conclusions

One of the main conclusions that can be drawn from this survey is that MNCs are not attracted to developing countries merely because tax incentives are being offered. Nor do they appear to be anxious to give up their

activities in high tax countries. This raises the possibility that developing countries offering tax incentives to multinationals for the setting up of import-substituting industries may perhaps have been over-generous in their offers, particularly if the new industries were also protected by import controls or tariff barriers. This argument however does not apply to tax exemptions offered in free-trade-zones for manufacturers for export.

Market considerations were seen to be the main reason for the presence of MNCs in third world countries. There was evidence, however, that MNCs appeared to concentrate their interests in geographical areas with which their home country had some political or historical connections.

Political uncertainty appears to be the main constraint on MNC activity in LDCs. Taxation is seen by MNC managers as a low-order problem causing less difficulty than any other environmental constraint listed in our questionnaire. Though many reasons were given as to why taxation is not a major constraint in LDCs, perhaps the main explanatory factor appears to be the presence of taxation in the home country of an MNC.

Judging by the results of all the surveys, multinational managers appear to

(a) be more aware than LDC managers of the ways in which taxation can influence business decisions,

(b) be less constrained than the latter by problems of taxation, and

(c) use tax-planning for the minimisation of their tax bill to a greater extent.

CHAPTER 8.

UK Multinational Corporations in LDCs - Analysis of Company Reports

The preceding chapters reported and analysed the results of surveys carried out to investigate the impact of taxation on business decisions in LDCs. Although the survey is the main method of investigation adopted in this research, the technique has a number of limitations as discussed in Chapter 3. One major problem with questionnaire- and interview-based surveys is the possibility of bias originating from functional specialisation or personal characteristics of the interviewee or officer completing the questionnaire. Evidence of this phenomenon was seen in the results of the test carried out within one firm, reported in the last chapter.

In order that our conclusions are not rendered invalid by the limitations of the survey method of research, it is intended to investigate the same issues using other data and techniques wherever possible. This chapter will analyse annual reports of UK MNCs to ascertain the factors reported as either promoting or constraining the activities of the companies in different geographical areas.

It is not contended that statements in reports accompanying annual accounts are to be taken as forming full and exhaustive listings of factors affecting operations of companies. However, these statements provide the main opportunity (in some cases the sole opportunity), that directors of public companies have of expressing their views on the activities for a given year to the shareholders, their investment advisers and other interested parties outside the companies. It is therefore reasonable to assume that any factors making a special contribution to the achievement of company objectives and others of significance hampering the achievement of corporate goals would be referred to in these reports.

Company reports will be analysed here to seek answers to the following broad questions:

1. What are the main factors promoting or constraining MNC activities in the third world?
2. How important is taxation among these factors?
3. Are the factors influencing activities in the LDCs any different from those in the home country or in other developed countries.
4. What specific aspects of taxation - particularly LDC taxation - do the companies
   (a) feel constrained by or
   (b) consider to be favourable to them?

Method

The method adopted in the study of company reports is 'Content Analysis'. Broadly speaking content analysis can be defined to include

> "... any technique for making inferences by objectively and systematically identifying specific characteristics of messages."(89)

More specifically, in practice it

> "... is a way of asking a fixed set of questions unfalteringly of all of a pre-determined body of writings in such a way as to produce countable results."(26)

The technique was first developed as an aid to communications research but has its applications both in the liberal arts and the social sciences. In enabling a researcher to classify the content of communications in a countable form it provides a vast improvement on impressionistic reading. As used in our research it involves analysing answers found in the selected published information to questions posed about factors affecting multinational operations.

The main communications analysed here are the annual reports of 24 UK multinational corporations with investments in LDCs for the year 1978 or the accounting year ending in 1978. The reports were a random selection from the collection of Company Reports held by the Warwick University Library. Most of the 24 companies are mainly in manufacturing industry: but mining, agricultural, shipping and agency services are also represented within the sample.

For each Company the following reports (if included in the annual report or circulated with it) were read and analysed:

a. Chairman's review,

b. Directors' report,

c. Report of non-executive directors and

d. Review of operations for the year.

The main question posed in the content analysis was 'What factors promote or constrain the achievement of company objectives?'

For this purpose unless specifically stated in relation to a given influencing factor, company objectives were assumed to be

a. maximisation of profits,

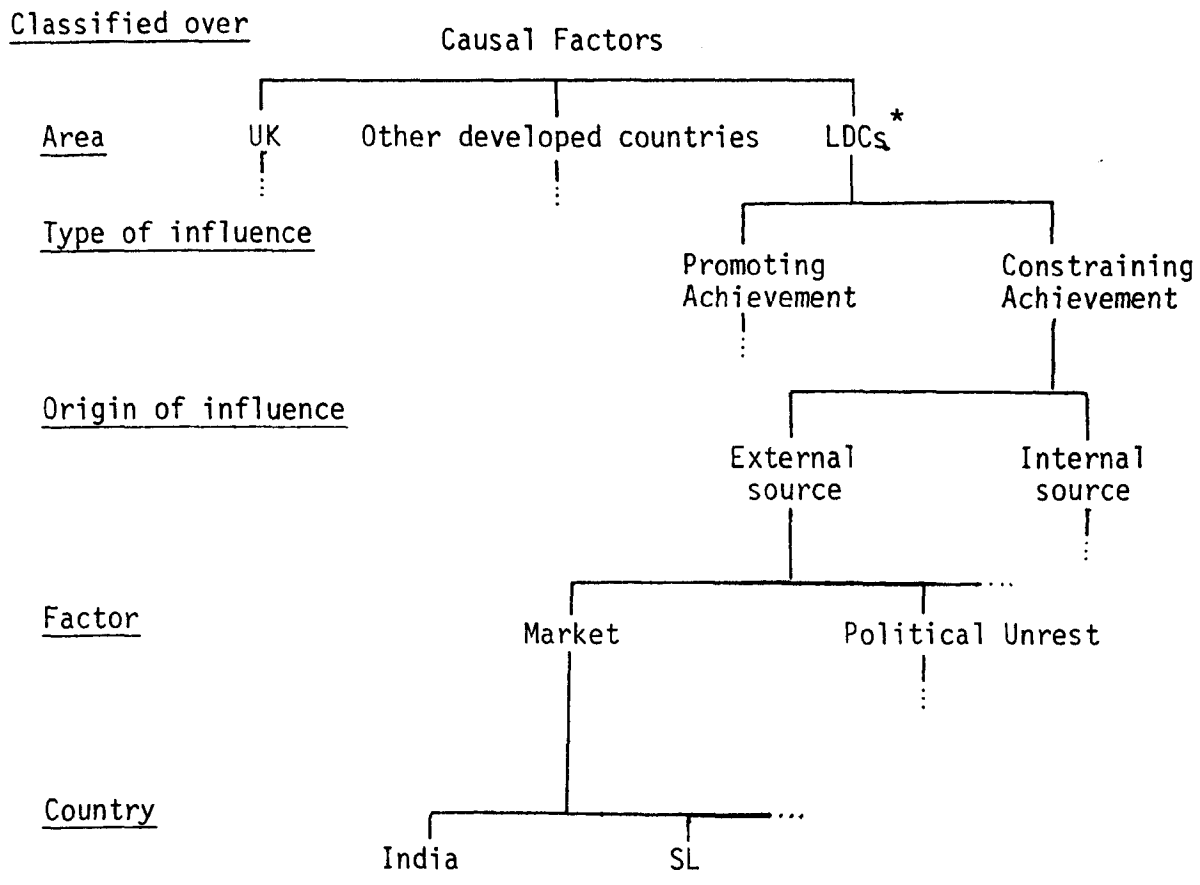
b. maximisation of sales and

c. growth of investment.

The causal factors referred to in the reports were classified separately for the UK, other developed countries and LDCs as internal or external factors promoting or constraining the achievement of corporate goals. As depicted in Figure 8.1, each class was further subdivided into categories with reference to the detailed causes given and countries to which the comments related.

Figure 8.1

Classification used in Content Analysis



* Similar classification done for other areas as well.

A number of rules were devised to facilitate the analysis:

1. Only comments relating specifically to a named country or geographical area identifiable as a collection of developed countries or LDCs were extracted.

2. Only factors referred to as causes for the company's failure or success in achieving its objectives in a particular area were extracted. For example, if the report thanked the management and staff for their hard work during the year (and most reports did) no account was taken of it. Again, if an acquisition was reported and no indication was given of its effect on the above objectives, no account was taken of that either. If however an acquisition was reported to have led to increased profits in a named country, then that was recorded as a factor promoting corporate achievement.

3. All comments on Rhodesia were ignored: most companies with interests in Rhodesia stated that the parent company in the UK had no influence over the operations in Rhodesia and hence Rhodesian results were not consolidated.

4. In the separation of internal from external variables, internal variables were defined as those factors within immediate control of management while all other influencing factors were treated as external variables.

5. A reference or several references in the same report to any one causal factor for performance in a named country or geographical area identifiable as a collection of developed or developing countries was given a score of one point under the appropriate category. For example, if a chairman's report stated that the poor profits in India were due to a prolonged strike by workers at the Indian factory, then this would carry one point under industrial relations problems and be classified as a constraint faced in LDCs.

Discussions of the technique of content analysis in the literature emphasise two areas of possible limitation associated with it:

(a) the suitability for analysis and completeness of the material analysed, and

(b) the quality of the questions asked and the relevance of categories for analysis as determined by the researcher.

Both these possibilities have been given due consideration in selecting the material for study and the questions posed. The questions asked are simple and straightforward and capable of being answered precisely. The material studied has been prepared by the companies for a uniform purpose, viz., informing the public and shareholders of the activities of the company for the year under review. It is not unreasonable to regard these statements as providing the best available public communications of company management relating to the activities of their companies during that period.

Statements made in the annual reports differ from survey responses in two material respects. Firstly the former are public statements whereas the latter are private and confidential communications made to the researcher. Secondly, as already discussed, it is possible that survey responses to some extent represent a personal view of the respondent and may be conditioned by his functional specialism or personal experience. Statements in annual reports by contrast are statements made by top management of the company; the ideas in the statements often passing through the hands of and being discussed by many of the management team before publication, and may be taken to be a better indicator of the corporate point of view.

Two important features of the material studied, which introduce possible sources of bias, must however be noted. Firstly, it was apparent that some companies provided shareholders with more detailed reports than others. The length of reports circulated and the extent of detail discussed appear to be

partially at least a function of the house style of reporting of the company concerned. The analysis carried out here would recognise internal strengths and weaknesses of companies and external constraints and advantages only if these were specifically referred to in the 1978 annual reports. We would therefore pick up only factors which were sufficiently important or different in the eyes of the company management to require mention in the reports. Also, our results would be likely to emphasise the problems and advantages of companies producing more detailed reports.

Secondly, the type of comment in the reports and hence in our results are also dependent upon:

1. the geographical spread of investments of the companies in the sample (for instance, if a company's only overseas investments are in LDCs, then its report will not have any comments at all about overseas developed countries),

2. the importance for group results of the investments in a particular country or area (for instance if the investment of a company in SL is very small in comparison with its total capital employed globally, it may not refer to conditions or performance in SL in its annual report whereas a much larger interest in, say, India may be discussed in detail).

Despite these limitations it is believed that the sample used is large and representative enough to provide reasonably good evidence on factors affecting MNC investments and performance.

Analysis of Results

The results of the content analysis are summarised in Table 8A.

Table 8A

Summary of Factors Influencing Achievement of Corporate Goals

	Type of Influence					
	Promoting			Constraining		
Source / Area	Internal	External	Total	Internal	External	Total
UK	37	8	45	0	56	56
Other Developed Countries	37	15	52	6	97	103
LDCs	13	14	27	0	84	84
Total	87	37	124	6	237	243

The summary in Table 8A shows that company reports referred to about twice as many constraining factors as those promoting the achievement of organisation goals. Both external and internal causal factors were mentioned but by and large external factors were constraints whereas the internal factors mentioned were mostly favourable. This difference between internal and external influences is statistically significant at a level of 0.001 (Appendix 15.1). This is not an entirely unexpected result when we consider that the annual report has,at least partly, a public relations objective: it is unlikely that management will volunteer detailed information on internal deficiencies and inefficiencies in a report seeking to maintain or increase the confidence of the shareholders and the public in the abilities of management. At the same time, it is not unknown for corporate management, to use annual reports to try to influence public opinion or the government in an attempt to remove or reduce some of the constraints faced by the company; thus introducing a bias towards reporting external constraints.

Looking at the factors promoting corporate achievement separately for the three areas, differences are observed in the balance between internal and external factors. Internal factors dominate the list of favourable influences in the UK. A shift to external factors is observed among overseas developed countries while in the LDCs external factors gain even more in relative importance. These differences are significant on the χ^2 test at a 0.01 level (Appendix 15.2).

It can be seen in Table 8A that companies refer to very few internal constraining factors in their annual reports. In this sample less than 3% of constraints referred to were of internal origin, and all these internal constraints related to developed countries outside the UK. Inadequate cell frequencies, however, preclude significant results on the χ^2 test.

On the whole, LDC operations appear to be those affected most by external factors. Viewing the combined influences of factors promoting achievement and those constraining achievement external factors are relatively more important in the LDCs. The relevance of external factors as against internal is somewhat lower in developed overseas countries and lower still in the UK. The differences are significant on the χ^2 test at a 0.005 level (Appendix 15.3). This relatively high frequency of references to external factors in LDCs might well reflect a greater dependence of MNCs on environmental influences in these areas than in developed countries.

Tables 8B and 8C list details of factors promoting corporate achievement and constraining corporate achievement respectively, classified as to source of influence (ie. internal or external) and ranked according to frequency of references.

Table 8B

Analysis of Factors Promoting Corporate Achievement - 1978

Internal	UK	Other Developed Countries	LDCs	Total
Productivity/cost reduction/ rationalisation etc.	10	10	1	21
Acquisitions/mergers/other similar arrangements.	3	10	4	17
New design/product development	8	8	1	17
Management effort/planning	5	5	4	14
Expansion	3	2	3	8
Marketing effort	5	1	-	6
Diversification	2	-	-	2
Divestment	1	1	-	2
External				
Market - demand/supply/prices	8	13	8	29
State of the economy	-	-	4	4
Fluctuation in currency exchange rates	-	1	-	1
Relaxation of price controls	-	-	1	1
Relaxation of exchange controls	-	-	1	1
Improvement in balance of payments	-	1	-	1

Table 8C

Analysis of Factors Constraining Corporate Achievement - 1978

Internal	UK	Other Developed Countries	LDCs	Total
Poor management	-	2	-	2
Excess/shortage of capacity	-	2	-	2
Teething troubles	-	1	-	1
Production problems	-	1	-	1
External				
Market - supply/demand/prices	16	33	13	62
State of economy	-	21	9	30
Industrial relations	14	4	8	26
Fluctuations in currency exchange rates	7	10	3	20
Availability of supplies and resources	1	4	11	16
Weather/climate	5	3	3	11
Requirements for local participation	-	-	11	11
Political-uncertainty/unrest	-	2	8	10
Price controls	4	3	3	10
Government intervention	4	5	-	9
Taxation	1	2	4	7
Difficult trading conditions	1	4	-	5
Devaluation	-	2	2	4
Balance of payments problems	-	-	3	3
Import controls	-	1	2	3
Inflation	1	1	-	2
Quality standards	-	2	-	2
Exchange restrictions	-	-	2	2
Credit problems	-	-	1	1
Dividend control	1	-	-	1
Common Agricultural Policy of EEC	1	-	-	1
Compulsory acquisition	-	-	1	1

Examining first the detailed factors promoting corporate achievement (Table 8B), 1978 appears to have been a year for concentrating on improvement of efficiency in both the UK and other developed country operations. Development of new products and designs is also important in the developed areas. Neither of these items however is particularly important in LDCs. This is again perhaps a predictable observation as much of any innovation and new developments in technology in a multinational can be expected to take place in a developed country environment with the new technology being transferred subsequently to LDCs.

Expansion of operations of multinationals has taken place in all areas including the LDCs, but successful merger activity is reported largely in respect of developed countries.

The only favourable external factor common to all areas related to the state of the market. This was also the largest scoring item among favourable factors. Though the availability of a market appears to be important in all areas, marketing effort by the company contributing to increased sales was only mentioned under the UK and developed countries, again supporting the survey evidence that a greater marketing effort is needed to capture and hold developed country markets.

Taxation or tax incentives were not mentioned by any of the companies as factors conducive to achievement of corporate goals. There were however seven references to taxation under factors constraining corporate achievement. Nevertheless, as seen in Table 8C, taxation was by no means a globally important constraining influence. It appears half way down the ranking of 22 external constraints referred to in the 1978 reports, carrying a score of 7 in a set of values ranging from 62 to 1. The aspects of taxation perceived as constraints will be discussed later in this chapter.

It can be seen from Table 8C that market factors are the most important

item under constraints as well as under factors promoting corporate achievement. Numerous statements were made in the reports regarding the 'state of the economy' of various developed and under-developed countries: this phrase or an equivalent was however not used with reference to the UK. It is possible however that as both the interest and awareness of the public are likely to be greater about the impact of the UK environment on corporate achievement, specific aspects of the UK economy would be referred to rather than the state of the economy in general. Industrial relations appear to have been a constraint creating greater problems in the UK than in any other part of the world in 1978.

The content analysis disclosed several typically LDC constraints such as (a) Government requirements for local participation, (b) shortage of supplies and services, (c) political uncertainty or unrest and (d) exchange restrictions. All these items echo the results of the survey in regard to LDC related constraints. However, political uncertainty in LDCs which loomed very large among the worries of survey respondents does not occupy the same high ranking among constraints referred to in company reports. It is, of course, possible that political uncertainty is an ever-present long-term problem in LDCs which will not necessarily have any special impact on the results of the year under review in most areas. It is reasonable to assume that company reports will not refer to this item year after year unless there was a particular impact in any year on the results in a specific area. The relatively low ranking of this item cannot therefore be interpreted to mean that political uncertainty does not exist in many LDCs or where it does that it is not perceived as a constraint by multi-national business.

An attempt was made to classify external constraints faced by MNCs into 3 categories: viz,

1. Market and resource related,
2. General country or economy related, and
3. Government controlled.

The results are detailed in Appendix 15.4 and a summary is given in Table 8D.

Table 8D

Classification of External Factors Constraining Corporate Achievement - 1978

	UK	Other Developed Countries	LDCs	Total
Market and Resource related factors	32	45	32	109
General Country and Economy related factors	13	37	27	77
Government controlled factors	11	15	25	51

The classification is in all probability not wholly accurate as available information was insufficient to fit some items into any one of the above categories with certainty, (eg. 'difficult trading conditions' may come under item 1 or item 2), while some others may be merely the secondary manifestations of other primary causes (eg. political unrest may arise from an unpopular measure of government control or vice-versa).

Subject to the above qualifications, the classification of external constraints using available data, discloses that of the three categories, 'market factors' are most important in the UK; that 'economy or general country related factors' are prominent in other developed countries and that government controls are most important in LDCs. The differences between geographical areas are significant on the χ^2 test at a 0.05 level (Appendix 15.4). These results add support to the survey findings that multinational corporations find government controls of one sort or another

to be the major constraint in LDCs, whereas commercial factors are found to be the major constraints in developed economies.

Test for continuity

The foregoing content analysis provides evidence of factors influencing the performances of UK multinational companies in the year 1978. A further question arising from the analysis is - 'would the results for 1978 be applicable in general for all periods in time?'

In order to establish the extent to which the results for 1978 may be used to draw generalised conclusions, a similar content analysis was carried out for 4 companies, selected at random from the main sample of 24, for the three years, 1972, 1974 and 1976.

The results of this second analysis are detailed and compared with the results of the first analysis in Tables 8E and 8F.

Table 8E lists factors promoting corporate achievement, classified as to source of influence and ranked according to number of references in the 1978 study. Table 8F provides a similar ranking of factors constraining corporate achievement.

These two tables show clearly that on the whole, factors affecting performance in the 4 company/3 year analysis are similar to those in the 24 company/1 year study. The second analysis added only one item to the list of constraints in 1978; viz., government red tape which was referred to once in the second set. Several items were, however, added to the list of factors promoting achievement; but these for the most part referred to reversals of factors listed under external constraint. Most items listed in the tables are common to both sets of data. The rankings in the two sets are not identical but there is some general agreement as to which items are the more common causal factors.

Table 8E

Comparison of Factors promoting corporate achievement

	4 Companies for the years 1972/4/6	24 Companies for 1978
Internal		
Productivity, cost reductions etc.	13	21
Acquisitions etc.	4	17
New design/product development	7	17
Management effort/planning	5	14
Expansion	6	8
Marketing effort	14	6
Diversification	1	2
Divestment	-	2
External		
Market	17	29
State of the economy	13	4
Fluctuation in currency exchange rates	2	1
Relaxation of price controls	-	1
Relaxation of exchange controls	-	1
Improvement in balance of payments	-	1
Government assistance	1	-
Improvement in availability of supplies and resources	2	-
Improvement in industrial relations	1	-
Tax reductions	2	-
Relaxation of dividend control	3	-
Relaxation of import control	1	-
Improvement in political situation	1	-

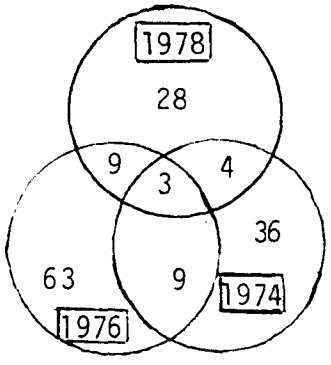
Table 8F

Comparison of Factors constraining corporate achievement

	4 Companies for 1972/4/6	24 Companies for 1978
Internal		
Management	-	2
Capacity excess or shortage	-	2
Teething troubles	1	1
Production problems	-	1
External		
Market	31	62
State of the economy	16	30
Industrial relations	4	26
Fluctuations in currency exchange rates	6	20
Availability of supplies and resources	16	16
Weather/climate	8	11
Requirement for local participation	2	11
Political uncertainty/unrest	9	10
Price control	17	10
Government intervention	8	9
Taxation	4	7
Difficult trading conditions	5	5
Devaluation	1	4
Balance of payment problems	-	3
Import controls	4	3
Inflation	12	2
Quality standards	-	2
Exchange restrictions	3	2
Credit problems	2	1
Dividend control	4	1
Common agricultural Policy	-	1
Compulsory acquisition	1	1
Government red-tape	1	-

Figure 8.2

Venn-diagram showing country-related factors affecting the performances of four companies in 3 years



Although there is general agreement between the results of the two studies as to factors influencing corporate achievement, it is not often that any company reports on any one causal factor for a given country year after year. Figure 8.2 shows that in a 4 company/3 year analysis, with a total of 180 causal factors, in only three cases was the same item repeated in respect of the same country in all three years. The majority of items were not repeated at all for any country by any one company. These results suggest one or both of the following possibilities: viz,

1. the influence of some causal factors are only felt in the short-term in any given country and they cease to be relevant after a short time either because companies take action to overcome disadvantages flowing from that source or because the source itself ceases to exist, and/or

2. the influence of some causal factors - internal or external - may continue in a country from year to year for long periods of time, but the company may not report them every year, particularly if other short-term factors come to the fore in the period under review.

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Views on taxation

It has been reported already that taxation did not occupy an important place among comments in company reports relating to factors contributing to or hampering corporate achievement. In the main content analysis of reports of 24 multinational corporations for 1978 we came across 7 comments relating to taxation. In the second study of 4 companies for the three years, 1972, 1974 and 1976, there were 6 references to tax. This section will analyse both sets together to discover the aspects of taxation to which companies are most sensitive. All comments in the reports relating to taxation are analysed in Table 8G.

There were two references to taxation as a factor promoting corporate achievement, both of which related to reductions in tax rates in LDCs.

In the remaining eleven comments, taxation was said to be a constraint: eight of these referred to indirect taxes; one referred to tax on profit distribution and two to tax rates in general.

Seven out of the eleven adverse comments on taxation dealt with developing countries and both favourable comments also related to the same area. Though the number of observations is small, it appears that multinational corporations are on the whole more concerned about LDC taxes than that in developed countries. The major irritant within the tax structure seems to be indirect taxation: these results correspond to the findings of the SL survey where high indirect taxation was the reason most commonly offered to explain why taxation was a constraint on the achievements of business in that country.

One interesting comment on indirect taxation which differs from the rest was made by a company with interests in Argentina. They found that

Table 8G

Analysis of Comments relating to taxation

A. Factors Promoting corporate achievement

Study	Area	Country	Comments referring to Indirect Taxes	Comments referring to Direct Taxes or general
4Co./3 year	LDC	India	-	Reduction in rates of Corporation Tax
		Pakistan	-	Reduction in rates of tax

B. Factors Constraining corporate achievement

Study	Area	Country	Comments referring to Indirect Taxes	Comments referring to Direct Taxes or General
24Co./1 year	UK	UK	Increase in VAT	-
	Developed	Denmark	Increase in Excise	-
		Australia	-	Change in tax rate
	LDC	India	High Import Duties	-
		Thailand	High Import Duties	-
		Argentina	Low Tariffs allow competing imports	-
		India	-	Crippling State and Central taxes
4Co./3 year	UK	UK	Increase in Excise	
	LDC	Sri Lanka	-	High tax on distributed profits
		Malaysia	Increase in Excise and new Sales Tax	-
		Lebanon	High Import Duty	-

C. Summary of All Comments

Area \ Type of Tax	Indirect	Direct & General	Total
UK	2	0	2
Other Developed Countries	1	1	2
LDCs	5	4*	9
	8	5	13

* Includes 2 favourable comments

low indirect taxes on imports were permitting competing imported products into the country. This kind of problem, however, is not frequently encountered in most LDCs where governments are usually quite willing to provide tariff protection to import-substituting industries.

Overall, therefore, taxation appears to be a matter of small concern to multinational companies, but judging by comments in annual reports, the companies seem to find LDC taxes to be somewhat more irksome than taxes elsewhere.

It will be recalled that some multinational interviewees were quoted in the previous chapter as saying that though tax rates were very high in some LDCs, they were able to earn higher profit margins in these areas. As a check on relative profitability of operations in LDCs against those in developed economies, all information on three items of financial data - viz, profits, turnover and capital employed - given on a geographical basis was extracted from the 24 company reports for 1978. Thirteen of the reports carried geographical analyses, though only a few of these produced analyses for all the items of data required. The geographical areas covered were not uniform for all reports: quite a few of the reports gave data for several continents in one figure. Nor was there uniformity in the definitions of the financial data reported. Profits reported in each case, however, were pre-tax profits.

Using available information, two indicators of profitability were calculated: viz. average ratio of profit to capital employed and average ratio of profit to turnover. The results are summarised in Table 8H. All items which could not be placed in any one geographical area (eg. results for "The Americas") were excluded from the computation. The schedule shows that both the ratio of profit to capital employed and the ratio of profit to turnover are higher for the geographical areas where LDCs are predominant.

Table 8H

Indicators of Profitability

Area	Average* Ratio of Profit/Capital Employed (A) %	Average* Ratio of Profit/Turnover (B) %	Number of observations forming average in (A)	Number of observations forming average in (B)
South America	21.8	20.6	3	2
Asia	21.2	13.6	3	6
Africa	13.2	15.1	4	8
North America	11.7	3.6	4	8
Australasia	10.8	9.6	4	9
U.K.	10.6	7.4	4	11
Europe	8.3	5.7	5	10

* Average ≡ unweighted arithmetic mean.

It must be acknowledged that under Asia may be included results of operations in Japan and under Africa those of South Africa, neither of which are developing countries. (The results for South Africa reported separately by one company have however been excluded from the results reported.) The above-mentioned qualifications limit the significance of conclusion drawn from the averages presented in Table 8H. Nevertheless the wide and clear pattern of differences between the developed and developing areas of the world provide supportive evidence of the ability of multinational companies to earn higher (pre-tax) profits in the LDCs. This result placed alongside other evidence discussed hitherto permits us to draw some tentative conclusions.

Firstly, if pre-tax profits of multinational corporations are larger in the LDCs than in developed countries, then the companies may not find

direct taxes to be a material constraint in the LDCs, even if the effective tax rates in some LDCs were higher than normal.

Furthermore, the "pre-tax trading profits" reported by UK companies would normally be computed after charging indirect taxes such as sales taxes, customs duties and excise. Reported pre-tax profits are therefore only "pre-direct-taxes". It was reported earlier that it was the indirect taxes in the LDCs more than direct taxes that appeared to trouble multinational investors. If profits after charging indirect taxes are higher in the LDCs than elsewhere, then even higher indirect taxes may be tolerable. Speaking generally therefore, it is possible to conclude that taxation could not be a factor reducing the economic viability of LDC investments to unacceptably low levels.

From another point of view, however, if profit levels are high in any area, then tax outflows will also be high even at moderate rates of tax. It is therefore possible that high pre-tax profits in the LDCs and the consequent magnitude of the tax-bill may make taxes an item for special executive attention in these areas, and hence an item to be commented upon in annual reports.

Finally, another possibility which may explain why MNCs show greater concern about LDCs taxes, even when profitability is higher in these areas, is that the companies may, in fact, be seeking higher profits in the LDCs than in developed countries. Higher profits and quicker payback may be sought in order to compensate for higher political (or other environmental) risks perceived by the companies in less developed areas.

Conclusions

The findings reported in this chapter are, on the whole, supportive of the survey results discussed previously. The main conclusions drawn from the content analysis of MNC annual reports are summarised below.

1. MNC performance is subject to greater influence of external factors in the LDCs than in the developed countries.

2. Differences were observed between developed areas and LDCs in the type of external influences affecting MNC performance. Governmental control has a relatively greater influence on LDC performance, whereas commercial factors dominate in the developed countries.

3. Taxation is not an important external influence in any part of the world, but available evidence (which is admittedly limited) indicates a somewhat higher sensitivity among MNCs to taxation in LDCs relative to that in developed areas. No such tendency was apparent in the questionnaire-based survey of MNC companies, however; and it is possible that what we see here is an indirect reflection of the relatively lower importance of other considerations in determining performance in LDCs.

4. From the limited data available it appears that indirect taxes are a greater irritant than direct taxes - a tendency observed in the SL survey as well.

5. Pre-tax profitability of MNCs appears to be higher in LDCs than in developed countries, indicating a relatively higher capacity to bear taxation in the former areas.

CHAPTER 9

Fiscal Politics in Sri Lanka

In the preceding chapters, the analysis of LDC business opinion reflected a fairly high degree of sensitivity to taxation among firms in the three countries studied: roughly half the business firms surveyed found that they were constrainted by taxation in the achievement of their objectives. In all three countries taxation was among the more commonly encountered environmental constraints. Nevertheless, LDC business firms did not appear to expend very much effort in tax planning; nor did they seem as aware of the implications of taxation for investment and financing decisions as the western Multinational corporations surveyed. The MNCs were less worried by taxation as a constraint but both more aware of and more ready to adopt tax minimisation practices.

Turning back to the LDCs again, we may ask the question: how does the business community of an LDC (as a social entity rather than as individuals or separate firms) react to taxation? Do LDC business men passively accept any and all taxes that are imposed on them, or do they in anyway try to exert influence in the shaping or reshaping of tax policy?

The literature of public finance acknowledges that fiscal policy is as much a product of political processes as of national economic priorities;[68] and that fiscal policy is formed through the interactions and the balancing of interests of all parties concerned - mainly the politicians, the public and various pressure groups.[141]

It has been argued that the democratic process of fiscal policy formation has an in-built bias leading to a size of public sector and level of taxation different from the sum of preferences of all participants. The theoreticians are however not in agreement as to the direction of the bias.[131,p.116] Some believe that a downward bias is present, because

individuals take into account only direct personal benefits accruing to them from the public sector and ignore all social benefits derived by society at large. Therefore in balancing the value of social goods against private goods, the former are systematically undervalued; the result being a downward bias in the size of the public sector and tax levels.

On the other side it is argued that the bias is towards expansion of taxation. Because the benefits of public sector goods may accrue to particular sub-groups in society while taxation is borne by all members of the society, it is argued that the sub-groups benefitting from public services will vote for a higher level of these services in the knowledge that their share of payment in taxes will be less than the value of benefit accruing to them.

Modern democracies, however, do not work in this simple and straightforward fashion. Further complications are added to the model by representative democracy where it is a body of elected representatives who make fiscal decisions. The politicians acting out of their own self interest will put forward programmes that will win them votes, and the voters, also from selfish ends, will back the party with programmes that satisfy their needs.(47) Under this system, whether or not there is an in-built bias towards overexpansion or underexpansion of taxation, there are bound to be some members of society whose preferences will not match the policies adopted via the democratic processes. These members may find the size of the public sector and the level of taxation fixed at a level either above or below their own preferences. If sufficient numbers of such dissatisfied members of society get together, they may form pressure groups to try to influence the policy-makers to change their minds, or even to attempt changing the policy-makers.(52)

Business firms are one such interest group who in most communities work collectively to make their views on matters affecting their interests known

to the government and the public. In the United States, per Musgrave and Musgrave,

> "Various taxpayer groups organize to represent their interests,... and the congressional tax committees .... are under great pressure from such groups whether it be the oil industry arguing for depletion allowances or the real estate lobby wanting faster depreciation ...."(131,p.120)

Not all pressure groups however will react to taxation in the same way; nor is it anticipated in theory that the persons subjected to such pressure will respond in a uniform manner in all circumstances. Bird and Oldman(16) believe that a low level of tax education among the public in LDCs will lead to less discussion of fiscal policies in these areas relative to developed countries. Peters(149) identifies four different types of interaction between pressure groups and the bureaucracy,viz.

1. "Legitimate" relationship - where there is required consultation between the pressure group and the administration.
2. "Clientela" relationship - where an interest group for whatever reason is accepted as a natural representative of a social sector, and becomes the reference point for administrators.
3. "Parentela" relationship - where there are kinship or close fraternal ties between the pressure group and the government.
4. "Illegitimate" relationship - where pressure group activity is outside the normal process of political action, but occurs anyway.

On the question of taxation, whatever the type of relationship between the pressure group and government, if the response of the pressure group to changes in taxation can be measured, it would enable an opinion to be formed of the sort of impact taxation has on the group. As our study focuses on the impact of taxation on private sector business as an interest

group, it would be necessary to identify, on the one hand, changes in taxation proposed by the government and on the other the relevant pressure groups representing business, and their response to new taxation proposals: this is the subject of discussion in the present chapter. New taxation measuresproposed by successive governments in Sri Lanka over a period of years will be analysed along with the response of business interest groups to such proposals in an attempt to understand the way in which Sri Lankan business is affected by taxation.

Methods

In this chapter, content analysis, supported by interview data will be used to study changes in tax policy in Sri Lanka and business response to such changes in the period 1965-1977.

Three different governments were in power in Sri Lanka in the period under review and the country had four different finance ministers in this thirteen year period. The fiscal policy of any of the governments is not to be found in one explicit policy statement, but can be gathered from many sources, the chief among which is the annual budget speech.[201] This speech also lists new revenue proposals and other changes in the tax structure which the finance minister intends to enact in the near future. The taxation measures proposed in each budget speech in this period will be analysed below.

The response of business to taxation will be measured as reflected in the following sources:

1. the annual reports of the Taxation Committee of the Ceylon Chamber of Commerce,[27]
2. all issues of 'The Ceylon Taxpayer',[92] described as 'the official organ of the Income Tax Payers' Association of Ceylon', and

3. the comments of leading businessmen, speaking as representatives of various business associations and trade chambers, reported in the national morning English language newspapers[5][93][182] on the two days after each budget day.

The Ceylon Chamber of Commerce is only one of many business associations in Sri Lanka: but it is the oldest, best organised association and has in its membership most of the large corporate business firms in the country. It is the only association with a separate taxation committee reporting annually to its membership.

Of the many other business associations in the country, several such as the Planters' Association of Ceylon and the Ceylon Tea Traders' Association are affiliated to the Ceylon Chamber of Commerce and operate more or less as part of the latter. Several other groupings have been created since independence to represent chiefly the small business sector and the individual entrepreneurs (the mudalalis) who for a number of reasons have not become associated with the Ceylon Chamber of Commerce. These groupings are however not as well organised as the Ceylon Chamber of Commerce, and as far as can be ascertained, do not have any published material on taxation spanning the period under review.

The Income Tax Payers' Association of Ceylon is the only organised pressure group in the country dealing exclusively with taxation matters. It has in its membership both business firms and individual taxpayers.

The publications of these two institutions and the post-budget comments in newspapers of representatives of these and other business interest groups are the only regular and recurrent published material available reflecting business response to taxation. These data will be analysed below.

Analysis and Discussion

Firstly the budget speeches made during the period were analysed to provide answers to the following questions:

1. How many tax proposals leading to changes in tax revenue are included in the budget speech, and
2. Would each such proposal lead to a higher or lower burden on the tax payer?

Each revenue proposal was also classified according to the type of tax measure involved.

Not all proposals put forward in the budget speech were brought into the analysis: the following were excluded:

1. Non-tax proposals,
2. Tax proposals dealing mainly with administrative matters such as the introduction of a PAYE scheme, and
3. Measures proposed to check tax evasion, with no immediate or direct impact on revenue.

In the analysis, any tax proposal leading to a change in the burden on the taxpayer is given a value of 1: with each proposal producing an increase in the tax burden being given a negative value (i.e. -1) and a proposal leading to a decrease in taxes being allotted a positive value (i.e. +1). It is not expected that all measures proposed would produce changes in the tax burden of equal amounts. It is not even believed that the changes in the burden would be of similar orders of magnitude for the different proposals. However, as no reliable estimates are available of the consequences of individual tax proposals, equal weighting of all proposals is the only satisfactory, objective basis for content analysis. Any attempt to attach weights to individual proposals would introduce subjective judgement of the researcher into the count and, hence, this alternative has been rejected. Overall, it is believed that the single weight counting system adopted will not yield distorted results as major and minor revenue proposals are fairly evenly spread over the years.

The results of the analysis are summarised in Tables 9A and 9B and details of tax measures concerned are given in Appendix 16.1. The annual totals of the number of revenue proposals in Table 9A provide an index of change in the tax structure (disregarding direction of change) brought about by successive budget speeches during the period. It will be observed that, in general, finance ministers tend to effect the largest number of changes to the tax structure in their first year of office. In this case 1965, 1970, 1975 and 1977 (all first years of office for the respective finance ministers) saw a high level of change in the tax structure. Other years, with two exceptions (viz. 1968 and 1974), had relatively few changes.

Of the two exceptional years, the 1968 budget speech contained many proposals as it announced the acceptance for implementation of a number of recommendations made by the Commission on Taxation appointed by the government, the intention to appoint which had indeed been expressed in the first budget of that government in 1965. The second exceptional year, 1974, had 19 proposals in the budget, but only 12 of these were subsequently implemented. This year was exceptional also in that cabinet opposition to some of the harsher tax measures proposed in this budget is believed to have led to the removal from office of the finance minister.

The tendency for new governments and new finance ministers to introduce many changes to the tax system shaped by their predecessors in office was also commented upon by several business and professional interviewees in Sri Lanka. At the time of the interviews in 1977, a general election was pending and a number of interviewees said they expected tax rates and incentives to change if there was a change of finance minister after the election, irrespective of whether the government also changed at the polls.

Table 9A

Content Analysis of Budget Proposals

Year	1965		1966		1967		1968		1969		1970		1971		1972		1973		1974		1975		1976		1977		Total		+ve Observations / -ve Observations
Finance Minister	A		A		A		A		A		B		B		B		B		B		C		C		D				
Effect on taxpayers*	+	-	+	-	+	-	+	-	+	-	+	-	+	-	+	-	+	-	+	-	+	-	+	-	+	-	+	-	
Type of Tax-measure																													
Income Tax -																													
- Individuals	3						5	1			1	2		1			3		5	2	3	1			3	1	23	8	2.88
- Corporate	1						1					1	1	2						2	1	1					4	6	0.67
Capital Taxes	1		1	1				1	1			1					2			2		1					5	6	0.83
Other Taxes	2		1	2	1	2	2	3		2	2	8	1	2		2	1	1			2	2			3	1	15	25	0.60
Incentives	3				1		2	2			2		2		2				1	5	6	2	1		6	6	26	15	1.73
	10		2	3	2	2	10	7	1	2	5	12	4	5	2	2	6	1	6	11	12	7	1		12	8	73	58	1.26
Net Value [i.e. + ve less -ve]	10		-1		0		3		-1		-7		-1		0		5		-5		5		1		4		15		
Total Number of Proposals	10		5		4		17		3		17		9		4		7		17		19		1		20		131		

* +1 ≡ proposal leading to a reduction in tax burden; -1 ≡ proposal leading to an increase in tax burden.

Table 9B

Budget Proposals

Analysed with respect to Finance Minister

Finance Minister	A		B		C		D	
Number of years	5		5		2		1	
Effect on taxpayer	+	-	+	-	+	-	+	-
Type of Tax Measure								
Income Tax - Individual	8	1	9	5	3	1	3	1
- Corporate	2	-	1	5	1	1	-	-
Capital Taxes	3	2	2	3	-	1	-	-
Other Taxes	6	9	4	13	2	2	3	1
Incentives	6	2	7	5	7	2	6	6
	25	14	23	31	13	7	12	8

[+ve Observations] ÷ [-ve Observations]

	1.79	0.74	1.86	1.5

The ratios of positive observations to negative observations for each type of tax change (final column of Table 9A) indicate that over the period under review there have been more reductions in the burden of personal income taxes than increases and that the taxpayers have had the benefit of a number of savings and investment incentives as well. The picture on corporate taxation, capital taxes and indirect taxes appears to be worse at the end of the period than at the beginning. From Table 9B it can be seen that this worsening of the tax burdens took place mostly in the period of office of Finance Minister B, a Trotskyite minister in a coalition of left of centre parties.

Details of the type of changes proposed (given in Appendix 16.1) show that during the study period, much of the benefits to individual tax payers have been in the form of personal and family allowances designed to enable them to keep up with inflation; and several concessions in capital gains taxes have also been made mainly for similar reasons. Corporate tax payers have faced several changes in their tax rates and have also received a number of incentives during this period. The increasing reliance of the State on new indirect taxes is also highlighted by these results. The results of the content analysis of budget proposals will be reviewed below against the response of business to these proposals.

If the Sri Lankan business community believed that new tax proposals made in the budget speeches would constrain their activities and if combinations of business interests formed pressure groups to press for the alleviation of the tax burden, content analysis of responses to the budget proposals should provide supporting evidence of this fact. The analysis now moves on to the three sources of data selected as reflecting business response to changes in tax policy of the government.

The first source analysed is the response to budget proposals reported in the national English language morning newspapers on the two days after each budget day; and the results are summarised in Table 9C.

Table 9C

Analysis of Newspaper reports on Response of Business Community to Budget Proposals

Year	1965		1968		1970		1974		1975		1977		Total	
COMMENTS ON EFFECT OF BUDGET PROPOSALS* ON GROUPS OF PERSONS	+	-	+	-	+	-	+	-	+	-	+	-	+	-
BUSINESS														
Private Sector	1				1		1				1		4	-
Small Investors and Small Business				1					1		2		3	1
Importers and Exporters				1								1		2
Tea Producers												1		1
Ceylonese Traders						1								1
Hoarders						1								1
													7	6
LABOUR														
Workers or Working Class	2	1			1				1		1		5	1
INDIVIDUALS														
Common Man/Consumers/The Masses				1	1						3		4	1
Lower Income Groups					1		1		1		1		4	-
High Income Groups						1								1
The Middle Class											1		1	
													9	2
													21	9
ON ECONOMY														
Development/Production	2		2	1	1						3		8	1
Prices/Cost of Living Inflation	2		1	1		1	1				3		7	2
Employment			1		1		1				1		4	-
Savings	1			1		1							1	2
Capital Formation	1		1										2	
Exports			1								1		2	
Availability of Goods & Supplies	1												1	
Government Revenue				1										1
Ceylonisation of Trade				1										1
Industrial Relations									1				1	
Free Trade											2		2	
													28	7
GENERAL REACTION														
General Statement of Approval or criticism	6		6	7	6		4		6		13		41	7
TOTAL COMMENTS	16	1	12	15	12	5	8		10		32	2	90	23

* + ≡ Favourable Comments

- ≡ Unfavourable Comments

Budget day in Sri Lanka is an annual event in which there is much public interest. The proposals of the finance minister to bridge the inevitable budget gap are, as in the UK, a well guarded secret until they are announced in the House, and UK practice is followed both in the presentation of the budget and discussions which follow both inside and outside parliament. Westminster tradition is imitated down to the 'black-box' in which the budget speech is carried by the finance minister. On budget day and days immediately following there is wide press and radio coverage of discussions of the proposals and the newspapers as a rule carry comments on the budget from representatives of business, trade unions and members of the public.

The persons interviewed on behalf of business interests are usually the presidents or other officials of trade chambers representing various business interests. For instance in 1965 (a fairly typical year), the following persons were interviewed:

1. Chairman of the Employers' Federation of Ceylon;
2. Secretary of the Ceylon Merchants Chamber;
3. President of the Ceylon Importers and Exporters Association;
4. Secretary of the Ceylon Chamber of Commerce and
5. President of the Sinhala Merchants Chamber.

These associations represent most of the major business interests in the country, but one observation that can be made about the interviewees is that in none of the years studied did they include any of the highly successful individual entrepreneurs known as mudalalis, or the top executives of local subsidiaries of MNCs. Though it is known that both Mudalali-owned and Multinational businesses are members of some of the above associations they do not appear to play leading roles in their respective associations.

Most comments on the budgets made by representatives of business (Table 9C) were of a general nature - being expressions of approval or disapproval of the budget proposals. A large proportion of the remarks referred to the likely impact of the budget on specific aspects of the economy such as price levels or economic development. Only a minority of comments (13 out of 113) dealt with the impact of budget proposals on the business sector. More attention was paid by the interviewees to how the budgets would affect other groups in society such as 'the workers' or 'the masses'. As against 13 remarks relating to business, 17 dealt with the impact of the budget on workers and other individuals.

On the whole, favourable comments far outweighed the adverse (90:23); but viewing the different groups of remarks in Table 9C separately, there were more adverse comments in the group relating to business compared with the other sections. Of the six adverse comments made relating to business, one, in 1970, referred to 'hoarders'. The interviewee in this instance, however, seemed to imply that hoarders, who were seen as an anti-social element in society, had been dealt with justly and that the Minister had merely demanded "his pound of flesh from the hoarders...." In all of the 113 remarks, only once was the impact of the budget on business profitability mentioned: this was in 1977 and related to the government's failure to reduce the burden of indirect taxation on tea producers.

In 1974, a year when a large number of budget proposals were made to increase income tax rates and to remove or reduce various tax benefits available to business, the representatives of the business community did not publicly acknowledge any possibility of an adverse impact of the budget on their activities.

As explained before, there were four different finance ministers in office in the period 1965-77 and two different political parties were in

power - the right-wing UNP from 1965 to 1969 and then again in 1977 and the more left-inclined SLFP with its coalition allies (forming the UF) from 1970 to 1976. If budget proposals and remarks of business interests are analysed over the periods in office of the two different parties (Appendix 16.2), it will be seen that:

(a) the majority of UF/SLFP budget proposals led to increases in the tax burden whereas the majority of UNP proposals were for tax reductions (difference significant at 0.025 level),

(b) there were more than twice as many remarks made on the three UNP budgets than on the three from the UF/SLFP,

(c) there were also relatively more adverse remarks on the UNP budgets (though significance of χ^2 is only at 0.25 level), and

(d) the relatively high number of adverse comments under the UNP regimes were however made in response to a set of budgets with fewer adverse proposals than in the UF/SLFP budgets.

Not only were the budgets presented under UNP governments relatively more favourable to taxpayers, the policies of the government in general were more sympathetic to private enterprise, and non-tax measures announced in the budgets were also more generous to business under the UNP. The extracts from the first budget speeches of the different finance ministers quoted below illustrate

(a) the difference between the two parties in their attitude to private enterprise and

(b) the apparent confusion in the objectives of the second UNP government whose aims for a free economy are expressed side by side with a desire to control 'capitalist' activity.

The apparently 'anti-capitalist' objectives of recent governments are believed to reflect the necessity (real or not) perceived by all politicians

in the country to adopt socialism (vaguely defined in its many shades of meaning) as a major campaign objective to gain or retain popular electoral support. This is however not a phenomenon unique to SL: in many other developing nations in Asia and Africa, businessmen have become a target for political hostility, often replacing in this function the former western colonial rulers.(8)

To quote from the budget speeches in support of the inferences drawn above, the first budget speech of the 1965-70 UNP government stated:

> "The principal objective of the National Government is to achieve a higher rate of economic growth than in the past ... The multiplicity of taxes and the high incidence of taxation in Ceylon have resulted in a reduction in personal and corporate savings ... A scheme of taxation which leaves in the hands of the private sector funds for the purpose of development and ensures that such funds are, in fact, used for development is thus an essential requirement."
>
> U.B. Wanninayake - Budget Speech 9.8.1965.

By contrast, the SLFP/UF budget in 1970 gave no encouragement to the private sector:

> "The programme of the UF ... assumes as its thesis that a developing country cannot leave development at the mercy of the inter-play of forces which are motivated solely by the profit instinct. It recognises that at this juncture private enterprise has a part to play in building up and exploiting the resources of the country but the leading part must be in the hands of the public sector."
>
> N.M. Perera - Budget Speech 25.10.1970.

After the break-up of the United Front in 1975, the new SLFP finance minister who followed Dr. Perera offered several concessions to private enterprise, but his policy objectives were decidedly against 'big-business'.

He said:

> "Our policies must ensure adequate incentives to work, investment and risk-taking in that part of the economy which is not directly State-controlled" (but) "It is essential that the system contain some form of in-built mechanism to prevent the abuse that goes with the unhampered concentration of wealth in a few hands and help build a new sector of medium and small-scale enterprises and co-operatives which lack some of the parasitic qualities which distinguish today's private sector."
>
> Felix Dias-Bandaranayake - Budget Speech 5.11.1975.

The UNP government which came back to power in 1977 is pledged to establish a free economy but their objectives as expressed in the budget speech are somewhat confused as regards their attitude to private enterprise. On the one hand their main policy objective in the budget is,

> "... to effect the transformation to a free economy as a necessary foundation for growth and development"

but at the same time they

> "... are determined to remove the ugly face of unbridled capitalism and to have a fair and just society based on democratic socialism."
>
> R. de Mel - Budget Speech 15.11.1977.

Some typical remarks made by representatives of the private sector in response to the above budget speeches will help to illustrate the non-critical public posture adopted by most of them.

<u>1965</u> "Mr. J. Abeywickreme, Hony. Secretary of the Ceylon Merchants' Chamber stated that the budget on the whole could be considered satisfactory. It had provided for some measure of capital accumulation in the private sector."

Ceylon Daily News 11.8.1965.

1970 "Mr. Francis Wanigasekere, Vice Chairman of the Ceylon National Chamber of Industries: A Herculean task well done by the Minister of Finance, who should be congratulated on a budget about which no one can grumble."

Ceylon Daily News 27.10.1970.

1975 "It is a sane, sensible and reasonable budget and the relief granted all round is most welcome and much needed, said Mr. Conrad Dias, Secretary of the Ceylon Chamber of Commerce."

Ceylon Daily News 27.11.1975.

1977 "Mr. H.R. Fernando, President, Federation of Chamber of Commerce and Industry of Sri Lanka .... We welcome the more liberal policies which will activate the economy..."

Ceylon Daily News 18.11.1977.

On the whole there was more praise than criticism of budget proposals from the private sector throughout this period. It is however noticeable that businessmen are more ready to criticise the budgets of a sympathetic government than those of a regime antagonistic to private enterprise.

The other sources of data analysed below provide evidence of a gradual decline in activity on the part of associations of business interests in making known to their members, the government and the public their views on fiscal policy.

The Ceylon Chamber of Commerce publishes annually a detailed report of its activities providing also statistics on most aspects of the economy and business activity. Included in the Chamber's annual reports are subsidiary reports of its Taxation Committee. Table 9D summarises the content analysis of expressions of this Committee's views on budget proposals and representations made to government by the Committee as reported in its annual reports.

Table 9D

Content Analysis of the Annual Reports of the Taxation Committee of the Ceylon Chamber of Commerce

Year	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
A. General Comments on Budget Proposals													
Expressions of Approval	1				1								
Expressions of Disapproval				1	1		1						
B. Representations Made to													
Finance Minister		1	3	1	1	1	1	1	2	2			1
Commissioner of Inland Revenue		4								1	1		
Prime Minister			3				1			1			
Other Ministers		1											
Tax Commission		1											
House of Representatives Standing Committee	1			1									
Government in General			1			1							
	1	7	7	2	1	2	2	1	2	4	1	0	1

It can be seen from Table 9D that

(a) general expressions of opinion on the budget and tax policy are very few and that all these are confined to the earlier years of the study period, and

(b) representations made to the government on taxation matters are greater in number in the earlier years.

The one exception to the low level of activity in later years in presenting the Association's view to the government is found in 1974, the year when a number of budget proposals were not implemented. The Chamber appears to have made an unusual (for them at the time) effort to represent views of business to the government in this year. The non-implementation of some of the more adverse proposals made in the 1974 budget suggests that they did manage to exert some influence on the government in this instance. It must however be noted that in this year there was not a single adverse comment made in public about the budget in the post-budget discussion in the daily press analysed in Table 9C.

It is possible of course that the relatively high level of activity on the part of the Tax Committee of the Chamber in the years 1966 and 1967 may have been encouraged by the fact that there was a government-appointed Commission on Taxation sitting at the time. Only one of the representations of the Chamber was to the Commission in these years: nevertheless the possibility that 1966 and 1967 were unusual years because of the interest in taxation matters aroused by the very appointment of the Commission cannot be discounted altogether.

However, the next source of data analysed - the journal of the Income Tax Payers' Association of Ceylon - provides further supportive evidence of a gradual decline of interest in taxation matters or an increasing unwillingness of businessmen to express their views on taxation in public. The results of the content analysis of this journal are summarised in Table 9E

Table 9E

Content Analysis of the Journal - 'Ceylon Tax Payer'

Year	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
Contents													
Editorials	2	3	3	2	2								
Views of the Association	1	4	1	1	1	2							
Views of Taxpayer		2	4			2		1	2	1			
Theoretical Articles		1	4	6	1	2					2	2	
Statements by or views of Tax Dept., Treasury or Officials of these departments	3		1	1	1	4	1	2	3	1	1		
	6	10	13	10	5	10	1	3	5	2	3	2	0

Table 9E shows that during the study period the variety in contributions to the journal had dropped considerably. The number of articles per issue too dropped over the years until in late 1976 the journal ceased publication altogether. The first item to disappear from the contents of the journal was the editorial: no editorials were published after 1969. No official statements of the views of the association appeared in the journal after 1970. Gradually over the years the journal of the Income Tax Payers' Association became a vehicle for giving wider circulation to new tax legislation and to administrative circulars of the Department of Inland Revenue. The views and opinions expressed in the journal in later years were mainly those of officers of the Inland Revenue Department or the Ministry of Finance. It must however be added that the President of the Association was interviewed in 1979 and his view was that the Association had become inactive in the 1970's because of the lack of interest of its office bearers at the time and the incompetence of its staff. He added that the Association was being reorganised and that the journal would commence publication in the near future. Nevertheless it is undoubtedly true that the trend of decreasing level of activity in this Association coincided with similar trends in other pressure group activities as well.

Taken together, the response to taxation in all three sources of data studied, indicates a decline in the 1970's of the level of activity by business pressure groups attempting to influence fiscal policy via public discussion or through direct representation to government. It is however not evident from the above analysis why this should be so. Has taxation ceased to be a problem to business or reduced in significance as a constraint on SL business over the seventies? Or has SL business learnt to live with an

adapt themselves to a background of high taxes? Alternatively is it that SL business was just as sensitive to taxes and that taxes were at least as much a constraint in the later years as in the earlier but that the channels of communication between business and the government had gradually narrowed during this period leaving a highly taxed and highly dissatisfied private sector - dissatisfied not only on account of high taxes but also their inability to discuss their problems with the authorities?

It is hypothesised here that the formal channels of communications between associations of business interests and the government had indeed been slowly stifled since the mid-fifties due to increasing reluctance on the part of governments to be seen to be sympathetic to owners of capital, and that this did lead to discontentment among certain sections of the business community. However it did not mean that there was no communication at all between government and business; nor that the business community had no influence whatsoever on government policies or administrative action of the authorities. The private sector had instead come to rely more on personal contact with members of the government as a means of communicating their views.

In the colonial times a number of very strong groups of business interests such as the Ceylon Chamber of Commerce and the Planters Association of Ceylon (dominated by British expatriate businessmen) wielded considerable influence over the colonial administration. Their relationship with the administration involved regular open consultations and were of the types described by Peters[149] as 'legitimate' or 'clientela'.

After independence, control over these associations passed into the hands of SL businessmen who for the first 7-8 years of independence enjoyed a continuing open dialogue with the authorities. It was during the SLFP governments in the late fifties and the early sixties that the relations between government and associations of business interests began to deteriorate.

At the beginning of our study period (in 1965) we see the business associations relieved at the return to power of a UNP government attempting to open a dialogue of the sort that existed with the previous UNP regimes. By then however the aspirations of the voters had changed considerably and as a consequence so had the priorities of the politicians. There was less willingness on the part of government to consult with business interests or to give in to their public demands and so be held before the electorate as protectors of the privileged few. Therefore though the 1965-70 UNP government did much to liberalise the economic environment in which the private sector operated, to simplify the tax structures and to reduce the tax burden on business, they were not as willing as in the past to engage in open dialogue with business interests. The ideological differences between business interests and the SLFP/UF government were even greater and this was perhaps the main reason for the sharp decline in business pressure group activity witnessed in the seventies.

As observed by Howard Wriggins in his discussion of Asian and African political systems

> "For the man in power, the resources and energies of entrepreneurs can be an important political asset. But a political leader may run substantial risks in conspicuously associating with the business community, because it is so widely looked down upon and distrusted. Where politics is an open, competitive affair and where opposition can be politically articulate and active, leaders are likely to avoid open alliance with businessmen ... Indeed it is most likely that the political leader will adopt public positions critical of the excesses of selfish business interests. Nevertheless, he may at the same time have tacit associations with particular elements of the business community."(197,p.82)

It appears that with the decline in open dialogue between business interests and the State, the traditional and everpresent personal networks of communications began to be even more important to SL business. There would be few business firms or individuals who were not able to or not willing to gain access to individuals in the establishment through personal contacts. In a small country, with a very small business elite connected in numerous ways with the elites of politics and the administration it would be quite out of character for a SL businessman not to use the traditional channels of personal communication to obtain a sympathetic hearing for his views. Information collected at interviews discussed below also supports this proposition.

Of the 30 business firms interviewed as part of the survey of business opinion, 21 firms commented on their channels of communication with the government. The method of communication used by these firms in making representation to government on taxation and similar matters are given in Table 9F:

Table 9F

Channels of Communication between Business and Government

Channel	No. of firms using
Communication through business associations	3
Representation by firm or through personal contacts	1
Both channels	17
	21

The seventeen firms using both business associations and other means were asked - "In your experience, which is more effective in making representations to government: business associations or personal lobbying?" Fifteen firms out of the seventeen replied that personal lobbying had been

more effective, while the remaining two firms were of opinion that neither channel had been effective for them. Of the two firms replying that neither means was effective, one was the local subsidiary of a large multinational group and the other a firm with substantial British shareholding. The chief executive of the MNC firm said:

> "... of course you must communicate, but in the situation in SL, I would not want to do it myself officially, or get one of the others (company executives) to do it officially. I'd much rather work through some Association like the Chamber of Commerce or one of the various bodies existing: where it isn't (the Company) speaking but it is manufacturing industry speaking. That's partly for political reasons."

There were a few firms among the interviewees who were either unable to or unwilling to use any but the organised channels of communications offered by their trade association, but they too were far from satisfied with the results obtained for them by the associations. One of these was of the opinion that:

> "It appears that even the Chamber prefers to toe the government line and not rock the boat too much ..."

Most firms benefit from personal contact with members of the government or the administration or both, and find these means to be more effective than the channels offered by trade associations in obtaining required results. Some companies, however, expressed the opinion that not all firms will be in a position to use personal influence over the authorities, or to do so to the same extent. The following are some illustrative remarks:

> "On principle, I think communication should be through the chambers. But we often use personal contacts. Often we do much of the work for the Association. The Association moves too slowly."

"The chambers are incompetent...."

"For this company personal lobbying is much more effective."

"Personal relations with officials in departments are very useful. We avoid such relationships with politicians."

The personal communications are, as can be seen above, not only with politicians: some firms have closer connections with the public administration and manage to obtain concessions at this level. The networks of communications originate from many different sources. Firstly, and the most important, is the network of the extended family. But there are many more communication channels criss-crossing the entire fabric of social and economic activity of the country; concentrated of course in the centre of political power and business activity - Colombo. To mention some of the more common communication channels - as an extension of the family there are the wider caste affiliations, 'old school ties', common religious affiliations, common political loyalties, connections that originate from common ancestral villages, present day neighbourhood, membership of clubs or charitable organisations, as well as networks of professionals: all these and many others are available to the businessman to use in correcting an injustice or obtaining a favour. In some spheres of government control and failing all channels of personal contact, there is the possibility of purchasing concessions with campaign contributions to politicians or with more direct and of course illegal bribery at various levels. This however is an area not covered by our investigations and it is not possible to comment on this aspect of SL life; except to note that several professional observers commented on the relatively uncorrupt administration in the Inland Revenue Department in comparison with other government agencies.

In order to obtain an understanding of the processes of communication between business and the government from the point of view of political

decision-makers, two senior politicians who have been involved in fiscal policy making in government were interviewed in 1979. Their views quoted below support the hypothesis of declining influence of organised business associations and increasing reliance on personal lobbying.

The first interviewee who was independent Ceylon's first finance minister, a senior member of all UNP governments since then and presently the President of the Republic appeared to have the same confused attitude to the private sector observed in the first budget speech of his finance minister. But his views substantiate the belief that much of the communication between business and the government takes place at a personal level. According to him:

> "There is less communication between us and business than what was found under the old UNP ... We are about the same as the SLFP... We do not encourage capitalist development except in the free trade zone... The private sector and the ministers all come from the same group. Ministers are related to businessmen who make their views known to the government in this way... In the preparation of a budget the finance minister does not take into account the opinion of the private sector. I did not, when I was finance minister... Many of my relatives are in business. I get to know their views when I meet them at various functions or parties and so on. Ronnie's (the Finance Minister's) family are also in business. We don't need business to make representations to us."

The other interviewee, the deputy finance minister between 1970 and 1975 and the main spokesman on economic affairs for the Trotskyite party the LSSP, said

> "... there is the Association of British Interests in Ceylon, the

Chamber of Commerce and similar chambers .. that function only as spokesmen for particular lobbies... The ABIC exerts a lot of influence on the British government who negotiate on their behalf.. The other channel is personal communications. Lots of people are related to other people and, Ceylon being a small country, that type of communication takes place more readily than in many other countries. The war-time and post-war rich had also entered the elite and they too are able to communicate at a personal level."

On being asked what part pressure from the private sector associations had played in the non-implementation of many of the 1974 budget proposals and the subsequent loss of office for the finance minister and his deputy, both interviewees answered that it was internal cabinet opposition that blocked the implementation of this budget and not formal representation made by various associations.

Conclusions

The first main conclusion that can be drawn from the foregoing analysis is that if SL business is becoming increasingly constrained in their activities by taxation, there are no outward signs of this fact reflected in their pressure group activity. The case in SL is not one where there has never been any organised pressure group activity among private sector business. What is observed is a gradual decline in pressure group activity in their attempt to influence taxation policy.

The evidence points to not a complete breakdown in communication between government and business relating to taxation and other matters, but a switch from organised pressure group activity to the more traditional practice of personal communication with those in authority. This switch

from a 'legitimate' or 'clientela' relationship to a 'parentela' relationship appears to have been found to satisfy most persons among both businessmen and politicians.

Though the practice of personal communication may suit the preferences of many of SL's business firms it by no means obtains satisfactory results for the business community as a whole. Those particularly inconvenienced by this change are the professionally managed, large, old established companies who have been unable to or unwilling to exert influence among politicians. Appointments in the seventies to the directorate of such firms of relatives of senior politicians in the ruling party of the time (the SLFP) were however believed by some professional observers interviewed, to be attempts to open channels of communication between business of this type and the SLFP where few had existed previously.

Two groups of business interests who do not appear to have made any public effort to influence public opinion or politicians in their favour have been the individual entrepreneurs (the mudalalis) and the MNCs. The most likely reason for the behaviour of the mudalalis is that they have at all times preferred and effectively used the traditional methods of personal communications or, failing that, resorted to buying their privileges. In the case of the MNCs, they perceive a greater threat toward themselves from the public and the politicians than that which is directed to local business. Feeling more vulnerable than the rest of business they prefer to keep a low profile in all public discussion and pressure group activity. In matters of major importance however they will use their home country government (who as western 'aid-givers' carry considerable influence) to negotiate on their behalf. These negotiations conducted at the diplomatic

level or higher are not well documented in published sources, but in recent times both the US and the UK governments are known to have intervened on behalf of multinationals operating in SL. On the nationalisation of petroleum distribution in SL the US government suspended all aid to SL until a quantum of compensation acceptable to the petroleum companies was agreed upon. The British government in more recent years diverted some of its aid funds to grant a loan to the SL government to be used in paying compensation to British owners of nationalised plantations.

The above observation that MNCs prefer to keep a low profile on matters of conflict with the government may, however, not be universally true of all MNCs. On the basis of interview evidence, Negandhi and Baliga have claimed that

> "there is considerable difference in the modes of handling conflict by US, European, and Japanese multinationals."(134)

Managers of US multinationals are said to be the most aggresive of the three groups whereas European and Japanese - especially Japanese - MNCs are said to adopt a low profile in situations of conflict with host governments.

It is possible that the high level of sensitivity to taxation as a constraint, observed among business in SL (and the other LDCs), is partly the consequence of an absence of open dialogue between business and government on matters of fiscal policy. The gradual decrease in the level of open dialogue in matters of fiscal policy, however, suggests that the reason for lack of discussion in SL at least is not the low level of taxpayer education as hypothesised by Bird and Oldman:(10) a higher level of public hostility to the business community is a more likely explanation.

CHAPTER 10.

TAXATION IN SRI LANKA COMPANY ACCOUNTS

The discussion so far has indicated that though taxation is seen as a constraint on their activities by the majority of SL business firms, there is by no means general agreement as to the impact of taxation on business decisions. The verification of some of the findings of the survey by means of an examination of company accounts is the objective of this chapter.

Published accounts are, in any country, the major source of information to outside analysts about the performance of business firms. These statements can usually be further analysed to provide additional insight into management policies and practices in the world of business.

Taxation is reflected in the final accounts of a business firm as a charge in the profit and loss account and a liability in the balance sheet. If the firm also provides for taxes deferred by capital allowances or other reasons, the deferred tax provisions too will appear on the balance sheet. The impact of taxation on company accounts need not, however, be limited to these directly tax-related items. If, as anticipated in theory, pricing policies, investment, financing, etc., of business are influenced by taxation, then the effect of taxes may be observable in other accounting variables as well.

What follows is an analysis of published annual accounts of a sample of SL business firms in an attempt

(a) to ascertain how taxation charges are reflected in these accounts,

(b) to study the relationships, if any, between taxation charges and other accounting variables, and

(c) to verify some of the views expressed in the survey of SL business on the impact of taxation on business policies and performance.

Methods

The method of study used in this chapter is Ratio Analysis: accounting statements of 20 firms over a period of 11 years have been analysed.

The sample comprises firms in manufacturing and service industries, all of which are public limited liability companies quoted in the Colombo Stock market.

The source of data for the study is the Rupee Companies' Handbook, published annually in the period under review by the Colombo Brokers' Association.(34) The handbook for each year gives summarised balance sheets and profit and loss accounts of all quoted companies for the previous year.

Apart from the plantation firms which formed more than two-thirds of the quoted companies in this period and which ceased to operate during our study period, there are not enough firms in any one activity to permit separate 'industry' samples to be picked for study. The number of firms in 'non-plantation' activities whose shares were quoted in the Colombo share market throughout the study period total less than 25: of these, twenty firms for which much of the information was available have been selected for study. Sub-samples of (a) manufacturing and engineering firms included in the main sample and (b) firms excluding those reporting pre-tax losses in any of the years have also been analysed.

The period covered is 11 years from the income tax year of assessment 1964/65 to year of assessment 1974/75. Expressed in terms of financial years, this gives a coverage of the 11 years commencing with the year ended 31st March 1964, or any accounting year-end falling within the preceding 12 months.

A financial ratio is merely a relationship between two financial variables: its main use is in providing a means of standardisation of financial information so as to facilitate comparison, aggregation or

observation of trends or relationships between variables in either inter-company or inter-temporal analysis. Such secondary information may, in turn, be useful in predicting future behaviour or performance of a company or groups of companies.(67)

The technique of ratio analysis in general and/or its particular applications have however attracted criticism on various grounds. These grounds for criticism can be divided into two main classes: firstly, those dealing with the deficiencies in the accounting data measurement or classification (for example, those originating in historical cost accounting valuations or the non-standard content or presentation of accounting statements), and secondly those relating to shortcomings in the mechanics of the analysis itself.(117)

It must be acknowledged at this early stage that our analysis in this chapter suffers from both types of shortcomings. For instance, there may have been material differences in accounting practice between companies in the sample. It is however not possible to ascertain the nature of any such differences or to adjust the data to produce comparable accounting bases. The accounting values used have been drawn from a secondary source, the Rupee Companies handbook, and though the compilers of the book had made an effort to present the accounts in a more or less standard format, all references to accounting methods and bases of valuation had been omitted. Moreover, the extent of undervaluations in the accounts due to historical cost accounting is not known: though it can be assumed that this is almost certainly not the same for all firms. Inadequate information however precludes the adjustment of accounting values to current values.

Another weakness associated with accounting data used in statistical analysis is that the distributions of such values are not generally of the normal form. Tests for skew and kurtosis carried out on the accounting

variables used below indicate that the present data base is no exception. Most of the data distributions analysed were found to violate the conditions necessary for accepting approximation to normality.[67,p.170] Much of the analysis of relationships between variables in this chapter has, therefore, been carried out by means of non-parametric correlation tests, using Spearman's rank correlation coefficient which is not underpinned by assumptions of normally distributed data.

It is a feature of accounting ratios that many ratios will have common components, often as a result of the mechanics of double entry accounting practices. Many different sources of correlation between any two accounting ratios, may, therefore, be present. This possibility has in fact been given due consideration in the analysis in this chapter.

The small size of the sample used, the fact that all companies in the sample do not operate in the same industry and non-random method of selection of sample provide other avenues for criticism of this study. These limitations would have to be borne in mind in drawing any conclusions from the following analysis.

Two ratios reflecting taxation in company accounts and a number of other ratios designed to test *a priori* expectations regarding business response to taxation have been calculated for every firm in the sample in respect of each year of the study period. Inadequacies in the source data have, however, meant that there are some missing values in the ratios, particularly in respect of ratios measuring corporate growth and new investment. Definitions of the ratios studied and conventions used in their computation are detailed in Appendix 17.1. Cross-sectional annual averages of all the ratios and their respective standard deviations are summarised in Appendix 17.2.

ANALYSIS AND DISCUSSION

The Corporate Tax Burden

In theoretical discussions of the burden of corporate taxation, there is no agreement as to the correct measure of the burden, as to whether it should be only the corporation income tax or whether taxation of corporate income should be viewed as including taxes charged on shareholders on receipt of dividends and capital gains.(99) In empirical investigations, the issue is further complicated by the fact that the effective tax charges on company accounts may not correspond to the statutory rate of tax due to the presence of various investment incentives. It is acknowledged that the actual payment of corporate taxes will normally lag behind the year in which the profits subject to tax are earned, but it is generally assumed that the tax provisions in company accounts will reflect the statutory rate of tax (adjusted for appropriate investment incentives).(40)

The analysis which follows suggests that there is some flexibility in making tax provisions in SL company accounts such that changes in the statutory rate may not be reflected in accounting tax provisions in the short-term.

Figure 10.1 offers a comparison of average tax provisions (TX) in company accounts in each of the years of the study period with the statutory rate chargeable for the year.

A priori expectations are that the average value of TX (which is the tax provision in the profit and loss account expressed as a percentage of profits before tax), would correspond to the statutory rate for the year. It is true that investment incentives, disallowable expenses,etc. will lead to differences between these two rates. Nevertheless, unless there are

FIG. 10.1 Tax charged in accounts v Standard Rate of tax

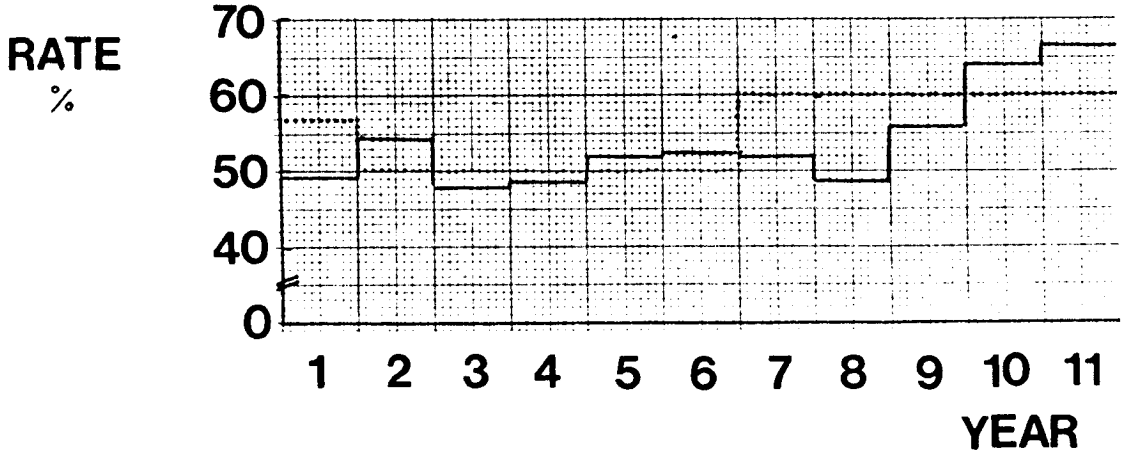
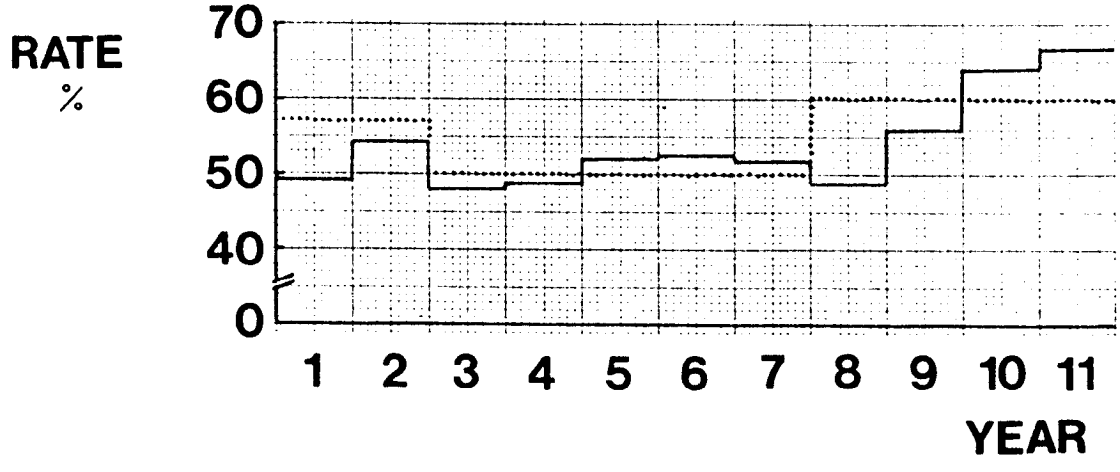


FIG. 10.2 Tax charged in accounts v Standard Rate lagged by one year



—— **actual average rate**

..... **standard rate**

major changes in such 'adjusting' items (and as far as can be ascertained, this has not been the case here) any changes in the statutory rate should be reflected in the accounting rate of tax (TX). It can be seen in Figure 10.1, however, that this is not true of SL company accounts. Tax charges in company accounts seem to take some time to catch up with changes in the standard statutory rate.

The main reason for such a delayed response, of course, lies in the operation of the tax system whereby changes in tax rates for any tax year are announced in the budget speech made during the year of assessment and the necessary legislation is enacted several months later. As corporate income is chargeable to tax on a 'preceding year' basis, this means that most companies would have finalised their annual accounts for the relevant year and probably even published them, by the time the new tax rate becomes law. Even if company accounts are published after the announcement by the finance minister of a change in the tax rate, there is no legal obligation on the company to provide for taxation at the proposed rate: strictly, the legal obligation arises only on the enactment of the new rate. In the intervening period, whether the new rate or the old rate is used in providing for the taxation liability appears to be entirely at the discretion of company directors with neither Company Law nor current auditing practice requiring otherwise.

Figure 10.2 provides a comparison of annual average tax provisions in company accounts with the statutory rate of tax lagged by one year, to allow for the delayed announcement of rate changes. This correction reveals a significant difference in the response of corporate tax provisions to the two changes in the statutory rate made during the study period. The accounting provisions for the first two years in Figure 10.2 are strictly not comparable with the other years as the former are based on reduced samples.

On examining the rates for other years, it can be seen that after the 7% reduction in the lagged statutory rate in year 3, the effective rate appearing on the accounts corresponded fairly closely to the statutory rate in each year of this low tax period. However, the 10% rise in the lagged statutory rate in year 8 did not work its way into company accounts until year 10. When the effective rate did catch up with the statutory rate in the last two years, it stood well above the statutory rate indicating an attempt by companies to make up for the earlier underprovisions.

The differences in corporate tax provisions between years under the high tax regime in years 8 - 11 are statistically significant.(168) The average provision in year 8 is significantly different from those in years 10 and 11 at a 0.05 level of confidence. The average provision in year 9 is significantly different from that in year 11 at a 0.1 level of confidence. During the period of lower taxes (years 3-7), however, no one year has an average tax provision significantly different from any other in that period.

It is of course possible that unusually high investment incentives in any year will push down the effective tax rate relative to the statutory rate. The additions to fixed assets in years 8 and 9 are however no larger than in the previous five years (see Appendix 17.2) and unusually high capital allowances are therefore unlikely to be a major contributory factor to the low tax charges in the 8th and 9th years. It is more difficult to establish that the charges in these two years were not reduced on account of tax holidays. However, tax holidays available in this period extended to more than two years and hence do not provide an adequate explanation for a dip in the tax charge for only two years.

The main reason for the delay in alignment of the effective rate with the statutory rate on the second change is the unusual delay in enactment of the tax increase. This increase which was first announced in year 7 as

a compulsory savings levy on companies (and a few months later changed by administrative decision to an increase in the standard rate) was enacted only in year 9. It appears that in the intervening period, the directors of some companies at least, preferred to exercise their discretion to make lower provisions at the old rate of tax.

Another possible contributory factor to this apparent flexibility in making tax provisions is that at the time of providing for the tax liability in the annual accounts, a company accountant or tax advisor is often called upon to make subjective judgements on the tax treatment of a number of issues such as disallowable expenses, asset category under which claims for accelerated depreciation allowances are to be made, likely outcome of additional assessments being contested and/or appeals pending in respect of prior years. Under conditions of such uncertainty, there is a likelihood that conservative provisions will be made in years when the profit position is good and that in years of poor profits, provisions would be biased in the opposite direction. The flexibility available to a company in this respect is limited as auditors would be unlikely to approve wide variations from year to year. Nevertheless, the possibility exists for a modest tax-buffer or a small back-log of tax provisions to be accumulated over the short-term.

The foregoing analysis does not provide conclusive proof as to the reasons underlying the apparent flexibility displayed in making corporate tax provisions, but it does show that the statutory rate of tax is not necessarily reflected in corporate tax provisions in the short-term.

The rest of this chapter will analyse accounting ratios reflecting corporate behaviour in a number of major business decision areas in order to verify some of the findings of the survey of SL business opinion.

Taxation and Corporate Profits

As discussed in Chapter 1, traditional theory of public finance envisages that the relationship between business profits and corporate taxes depends on the market conditions under which the firm operates.[131] It is argued that, in the short term, a firm operating under either perfect market conditions or monopoly conditions will not be in a position to shift corporate income taxes and that any increase in taxation will result in a reduction of earnings to capital. The position of firms operating under oligopolistic market conditions may be different: these firms may be merely satisficing on profits and if so, will be able to shift the burden of additional taxes, in the short-term, so as to maintain their profits at desired levels. It is, however, acknowledged that in the long-term market supply and demand changes may result in the shifting of taxes in all types of firm.

An exception to these traditional views is to be found in the work of Krzyzaniak and Musgrave[112] who argue that business firms treat taxes as a cost when determining prices and a change in the tax rate would therefore lead to an adjustment in prices.

As discussed in Chapter 1, empirical evidence in developed countries is not wholly supportive of either of the above positions.[112][40][191]

The survey evidence in SL (reported in Chapter 4) disclosed that though turnover taxes (BTT) were an important consideration in the pricing decisions of SL firms, the same was not true of income taxes. The prices of firms not restricted by price control or international commodity prices appeared to be based on costs including BTT plus a standard mark-up; with the mark-up providing for both profits and income tax. This practice implies that the firms are unlikely to attempt shifting of an increase in income taxes in the

short-term, but does not necessarily preclude long-run shifting by adjustment of the required mark-up in cost-plus pricing.

In the literature on tax-shifting, the short-term is defined as the period during which the possibility of capacity changes in response to a tax are excluded.[112] On the other hand, the short-term in relation to pricing decisions is best defined as the period during which prices may change but not overall pricing policies: and it must be acknowledged that the short-term in the two different contexts need not necessarily coincide.

The analysis in this section suggests that

(a) SL business have been able to shift taxes in the long-term, and

(b) shifting has been practised even in the short-term but this appears to have become more difficult in the later years of the study period.

The impact of taxation on profits of companies (whatever the corporate response to taxes) should be observable in the annual accounts. Let us assume firstly that shifting is defined in terms of returns to holders of equity capital (i.e. if a company is able to shift taxes, it will attempt to maintain returns to equity by shifting action), and, secondly, that in the absence of corporate income taxes, firms have similar potential returns to capital employed. Then, on the one hand if income tax is shifted,

(i) a positive correlation should be observed between the ratio of tax charge to profit before tax (TX) and profits before tax expressed as a percentage of capital employed (PBT), and

(ii) there should be no systematic relationship between TX and profits available to equity holders expressed as a percentage of equity holders' interest in capital employed (RTO).

However, on the other hand, if income tax is <u>not</u> shifted,

(i) a negative correlation should be observed between TX and RTO, and

(ii) there should be no systematic relationship between TX and PBT.

The assumption made above that, in the absence of income taxes, there is equivalence of profitability among companies, is a major limitation in the analysis. It is extremely likely that profits of individual firms in the sample will be a function of a variety of non-tax influences. Nevertheless, it is not unreasonable to expect that evidence of business response to income taxes will be observable in a test of correlation between taxes and profits. A correlation test will not, however, indicate the degree of shifting. Nor will it disclose the mechanisms by which tax shifting, if any, comes about. Limitations in the availability of data preclude the investigation of these questions.

The tax and profit ratios examined are all annual values (or study-period averages of annual ratios) and should therefore reflect both the short-term and the long-term response to taxes.

The results of cross-sectional correlation tests based on Spearman's rank correlation coefficient are summarised in Tables 10A and 10B. The results in Table 10A relate to tests on averages for the 11 year study period carried out for the whole sample as well as for two restricted samples: viz., (a) manufacturing and engineering firms and (b) firms which did not report losses before tax in any of the years in the study period.

It can be seen in Table 10A that for all three samples there are positive correlations between average ratios of PBT and TX, significant in each case at a level better than 0.05. In contrast, the relationship between average ratios of TX and RTO is not significant at the 0.05 level, though some positive correlation between these two variables is seen in all three cases.

Table 10A

Spearman's Rank Correlation Coefficients between Profits and Taxes
- For Average Ratios 1964-74

Variables	N = Sample Size	Spearman's r	Level of significance
(A) TX v PBT			
(i) All firms	20	0.64	0.01
(ii) Manufacturing and Engineering Firms	14	0.72	0.002
(iii) Firms not reporting losses	16	0.55	0.01
(B) TX v RTO			
(i) All firms	20	0.29	0.11
(ii) Manufacturing and Engineering Firms	14	0.19	0.26
(iii) Firms not reporting losses	16	0.39	0.07

Table 10B

Spearman's Rank Correlation Coefficients between Profits and Taxes
- Summary of Annual correlations

Variables	Total Number of correlations		Significant at level of 0.05 or better		Significant at level of 0.1 or better	
	+ve	-ve	+ve	-ve	+ve	-ve(years)
(A) TX v PBT						
(i) All firms	9	2	3	1	7	1 (year 11)
(ii) Manufacturing and Engineering firms	8	3	3	1	5	1 (year 11)
(iii) Firms not reporting losses	10	1	2	-	7	-
(B) TX v RTO						
(i) All firms	3	8	-	3	-	3 (years 9-11)
(ii) Manufacturing and Engineering firms	-	11	-	2	-	3 (years 2, 10 &11)
(iii) Firms not reporting losses	5	6	-	4	-	4 (years 8-11)

Subject to the limitations of *ceteris paribus* assumptions underlying the analysis, the significant positive correlation between TX and PBT can be interpreted as being indicative of the ability of business firms, by and large, to earn high profits to cover high taxes and to shift the burden of high taxes away from the owners of capital. The absence of a negative correlation between TX and RTO suggests that by and large, in the study period, owners of equity have not been called upon to bear the burden of taxes falling on the companies liable to high taxes. The fact that the above observations have been made in respect of averages over an 11 year period indicates that the correlations are not merely the result of short-term flexibility in making tax provisions discussed in the previous section. The evidence, on the whole, therefore points to the presence of some tax shifting in the study period.

Turning next to the results of correlation tests for individual years, summarised in Table 10B (detailed results are to be found in Appendices 17.3 to 17.13), the overall picture in regard to the presence of tax shifting is not changed, but a feature of further interest emerges in that the later years of the study period appear to be different from the earlier years.

Table 10B discloses the following:

(a) Correlations between PBT and TX are predominently positive and the majority of these are statistically significant at a level of 0.1 or better. The only statistically significant negative correlations between these two variables are to be found in year 11; and

(b) as between RTO and TX, negative correlations are predominant, but only those in later years are statistically significant at levels better than 0.05 (though one negative correlation in the

second year is significant at the 0.1 level).

As discussed in the previous section, the early part of the study period was a relatively low-tax period, as the statutory rate of tax had been reduced by 7% in Year 2. In the latter part of the study period there was a 10% increase in the statutory rate, resulting in a gradual increase in tax charges in company accounts. The statistically significant negative correlations between RTO and TX in the later years are indicative of the firms' inability (or reduced ability) to shift taxes following the rise in tax rates. This raises the possibility that tax-shifting behaviour may be different as between an increase and a decrease in taxation.

The appearance of significant negative correlation between PBT and TX in the last year, however, suggests that both pre-tax profitability and the ability to shift taxes may have been influenced by other, non-tax, factors. Though positive proof is not available in company accounts, it is possible to speculate that price controls introduced in the early seventies (and emerging in the survey of SL business opinion as a significant constraint on the achievement of business objectives) may have been a causal factor contributing to the negative correlations observed and the apparent inability of firms to shift taxes in later years at the levels existing in earlier years.

As stated before, the analyses in this chapter have been carried out largely in terms of non-parametric correlation tests on account of the non-normal distribution of much of the data analysed. Pearsonian correlation tests have, however, been carried out and these were seen to support the findings of the rank correlation tests detailed above. Results of Pearsonian correlation tests on average ratios for the main sample are given in Appendix 17.14.

The above analysis did not enquire into the causes for variation in the effective tax burden (as measured by TX) among companies facing the same tax environment. The main tax-related reasons for such differences among going-concern firms will be (a) differences in asset structures and consequently in book depreciation charges which are disallowable for tax purposes, (b) differences in the levels of other disallowable expenses which will not be deductable in the computation of taxable income, (c) tax holiday benefits or receipt of tax exempt income, (d) differences arising from the receipt of accelerated capital allowances on the acquisition of depreciable assets and (e) the presence of brought-forward tax losses.

The possibility that the presence of loss-making companies in the sample may bias the results of correlation tests has been recognised and the tests have been run for the sample excluding firms reporting pre-tax losses in any of the years. It can be seen from Tables 10A and 10B that the exclusion of loss-making firms from the sample did not greatly alter the pattern of relationships observed.

As regards tax holidays and tax-exemptions, though it is true that the receipt of tax-exempt income can distort the value of TX, there is no reason to suspect that the presence of such income will be associated with any particular level of income so as to introduce a bias to correlation results.

Differences relating to accounting depreciation and capital allowances for tax purposes will (under conditions, observed in the next section, of positive correlation between additions to fixed assets on the one hand and measures of profitability on the other), induce negative correlations between TX and both measures of profitability. The presence of disallowable expenses in income statements would also tend to bias the relationship between tax and profitability in a similar direction. However, any correction for such

bias could only improve the significance of our results in reflecting the shifting of income taxes: and, therefore, the inability to introduce a control for such bias should not detract from our conclusions.

On the whole, therefore, the evidence points to the presence of short-term as well as long-term tax shifting (though apparently diminished in later years): the short-term being defined in the context of tax shifting. The question then arises as to how these observations could be reconciled with the claims of business firms interviewed, that income tax is not treated as a cost in cost-plus pricing. As suggested in Chapter 4, the most likely explanation is that the mark-up on cost (which was said to provide for income taxation as well as profits) must be adjusted at regular intervals such that there is in effect short-term, even if not immediate, tax-shifting following a change in tax burden of income tax.

Taxation and Investment

As discussed in Chapter 1, the theory of public finance envisages a negative correlation between the burden of taxation and business investment under a tax regime in which all costs of capital are not tax-deductable. Empirical evidence, though largely supportive of the direction of the relationship,has tended to suggest a not very elastic response of the level of investment to changes in taxation.

The survey results on the influence of taxation on business growth and investment discussed in Chapter 4 indicated a low sensitivity to taxation in this area of business decision-making among SL firms. Taxation was not a major reason for the non-achievement of investment plans, and a majority of survey respondents did not find taxation to be a constraint on business growth. However, tax-related investment incentives were considered to be

the most useful forms of incentive on offer. Even among those who found taxation to be a constraint on growth, management type, rather than level of growth, appeared to be the dominant determinant of sensitivity to taxation.

The following analysis of company accounts shows no strong relationship between investment and taxation.

If theoretical expectations are realised, it should be possible to observe a significant negative correlation between tax charges and investment. Table 10C summarises the results of correlation tests carried out between measures of investment on the one hand and measures of profitability and taxation on the other. Investment for our purposes has been measured using two separate ratios, viz:

(a) additions to fixed assets in a year expressed as a percentage of fixed assets at the beginning of the year (AFA), and

(b) the increase in total assets in a year expressed as a percentage of total assets at the beginning of the year, (ITA).

For a majority of cases in the sample, data relating to measures of investment were unavailable in respect of one or more years. Averages for the study period have therefore not been used in this section. Details of the correlation results summarised in Table 10C are to be found in Appendices 17.3 to 17.13.

It can be seen in Table 10C that in the total sample, there appears to be no systematic association between tax (TX) and the measures of investment (AFA and ITA), whereas positive and mostly significant relationships are observed between the measures of profitability (PBT and RTO), and measures of investment. Restricting the sample to profit-making firms makes little or no difference to these results, but a negative shift to all relationships

Table 10C

Spearman's Rank Correlation Coefficients relating to Investment

- Summary of Annual Correlations

Variables	Total Number of correlations		Significant at level of 0.05 or better		Significant at level of 0.1 or better	
	+ve	-ve	+ve	-ve	+ve	-ve
AFA v TX						
(i) All firms	5	6	-	1	-	1
(ii) Man. & Eng. firms	4	7	-	3	-	4
(iii) Firms not reporting losses	7	4	-	-	-	1
ITA v TX						
(i) All firms	6	5	-	2	-	2
(ii) Man. & Eng. firms	4	7	-	2	-	2
(iii) Firms not reporting losses	5	6	1	1	1	2
AFA v PBT						
(i) All firms	11	-	3	-	6	-
(ii) Man. & Eng. firms	7	4	-	1	1	1
(iii) Firms not reporting losses	10	1	4	-	4	-
ITA v PBT						
(i) All firms	11	-	3	-	4	-
(ii) Man. & Eng. firms	9	2	4	-	5	-
(iii) Firms not reporting losses	11	-	5	-	9	-
AFA v RTO						
(i) All firms	10	1	3	-	7	-
(ii) Man. & Eng. firms	9	2	2	-	3	1
(iii) Firms not reporting losses	10	1	5	-	5	-
ITA v RTO						
(i) All firms	11	-	4	-	7	-
(ii) Man. & Eng. firms	10	-	3	-	4	-
(iii) Firms not reporting losses	11	-	5	-	7	-

tested is observed in the sample of manufacturing and engineering firms. Nevertheless, it is fair to say that, overall, no strong negative relationship of the sort expected on the basis of theoretical analysis is observable for these firms. The absence of significant negative correlations between TX and measures of investment, however, matches the findings of the SL survey that taxation was not a major constraint on business investment and growth.

Why the theoretical expectations of negative correlations should not be realised for these firms is not immediately clear from these results. Many different factors could have contributed to the results observed, but one possibility, that is supported by the positive correlations observed between investment and profitability as well as by the relationships between tax and profitability observed in the previous section, is that taxation is not an inhibitor of investment because it has largely been shifted during the study period. If taxes are shifted so that they do not affect levels of profitability, then they will exert no influence on investment via investment returns and there will be no significant negative correlations between TX and investment (though longer term influences felt via changes in market supply/demand conditions cannot be predicted).

It must be acknowledged that the annual tests of correlation of the sort carried out here are not ideal for testing the influence of profitability on investment, as short-term fluctuations in these variables may produce values not strictly representative of long-term trends. Two separate analyses have, however, been carried out between average profits for three year periods and investment in the third year of each period and results obtained were seen to correspond to those of the annual tests.

Annual correlation tests are, however, particularly relevant for testing one aspect of the relationship between taxation and investment -

i.e. the effect of accelerated capital allowances on the tax burden. Given the system of accelerated capital allowances operating in SL, the absence of significant negative correlation between TX and AFA is difficult to explain. One possibility is that timing differences are adjusted for in the accounting tax charges by means of provisions for deferred taxation. However, SL company law does not require deferred tax provisions to be made and only 5 of the firms in the sample made any provisions termed 'deferred' or 'future' tax provisions. The exclusion of these firms from the sample, made no significant difference to the results. Another possible explanation for the absence of negative correlations between TX and AFA, though unproven, is that capital allowances are largely equal to or proportional to book depreciation allowances so as to eliminate significant correlation between TX and AFA. The improved significance of negative correlation between TX and AFA in the relatively more homogeneous sample of manufacturing firms, however, offers some weak evidence of the effect of accelerated capital allowances on the tax burden.

On the whole, there is no strong evidence in the above results of taxation inhibiting investment, thus lending support to the findings of the survey of business opinion. The results, however, cast doubt on the effectiveness of investment incentives offered through the tax system, despite the views expressed by business managers that these were the most useful form of incentives on offer.

Taxation and Financing

In the presence of a tax system in which interest payments are deductable in computing taxable income, theoretical analysis leads us to expect increased gearing to produce increased returns to owners of equity. As discussed in Chapter 1, theoreticians do, however, acknowledge that real life market imperfections will exert contrary influences such that

the maximum benefits of the tax-shield on financial gearing may not be availed of.

The survey of SL business opinion (in Chapter 4) disclosed that taxation was not a major consideration in financing decisions of firms in that country. Only a minority of respondents believed that taxation influenced their financing decisions, and even these firms were more concerned with the influence that taxation imposed via its effects on liquidity than with the advantages of the tax shield on gearing.

The analysis below shows no apparent profit advantages to gearing, though taxation and gearing levels are seen to be systematically related.

Several new ratios have been used in this section. These are,

(a) LS, a measure of gearing, which is non-tax liabilities at the end of the year expressed as a percentage of total assets held on that date,

(b) TP, which is tax payable at the end of the year expressed as a percentage of total assets.

(c) CI, which is cash and bank balances and short-term investment held at the end of the year expressed as a percentage of total assets, and

(d) DRS, which is total debtors at the end of the year expressed as a percentage of total assets.

If theoretical expectations regarding profit advantages resulting from the tax shield are realised, we would expect to find a positive correlation between gearing (LS) and measures of profitability (PBT and RTO) though it is by no means claimed that these variables will not be influenced by other factors. The tax shield will not however produce any systematic relationship between tax charges in company accounts (TX) and gearing levels (LS).

If, as claimed by survey respondents, there is a liquidity-based connection between taxation and gearing, a correlation may be observed between TX and LS. As taxation was believed by respondents to limit borrowing capacity by reducing the debt-servicing capacity of firms, *a priori* expectations are that negative correlations should be observed between TX and LS.

Correlation tests were carried out between relevant variables both for study period averages and annual ratios. The results are summarised in Tables 10D and 10E.

Table 10D

Spearman's Rank Correlation Coefficients relating to Corporate Gearing - For average ratios 1964 - 1974

Variables	All Firms N = 20 Spearman's r	Level of Significance
LS v PBT	-0.26	0.14
LS v RTO	-0.10	0.34
LS v TX	-0.39	0.05
LS v TP	-0.65	0.001
LS v CI	-0.53	0.008
LS v DRS	0.24	0.15
TP v TX	0.62	0.002
TP v CI	0.42	0.03
TX v CI	0.44	0.03

Tables 10D and 10E summarise results of correlation tests only in respect of the total sample. Similar tests have, however, been carried out for the two restricted samples and the results were seen to be in general agreement with those pertaining to the total sample. Details of annual

Table 10E

Spearman's Rank Correlation Coefficients relating to Corporate Gearing - Summary of Annual Correlations

Variables	Total Number of correlations		Significant at level of 0.05 or better		Significant at level of 0.1 or better	
	+ve	-ve	+ve	-ve	+ve	-ve
LS v PBT	1	10	-	1	.-	4
LS v RTO	2	8	-	2	-	2
LS v TX	-	10	-	1	-	3
LS v TP	-	11	-	11	-	11
LS v CI	-	11	-	8	-	9
LS v DRS	11	-	9	-	10	-
TP v TX	10	1	9	-	10	-
TP v CI	11	-	7	-	8	-
TX v CI	10	1	1	-	2	-
LS v AFA	10	1	1	-	4	-
LS v ITA	10	1	3	-	3	-

Spearman's rank correlation results for all samples and the results on average ratios for the restricted samples are given in Appendices 17.3-17.13 and 17.15 respectively. Pearsonian correlation tests were also carried out on these variables and the results were seen to be in general agreement with those of the non-parametric tests. The Pearson's correlation results in respect of study period averages for the total sample are summarised in Appendix 17.14.

The results in Tables 10D and 10E disclose no significant positive correlations between level of debt (LS) and the two measures of profitability (PBT and RTO): instead the relationsip between these variables is negative in most years of the annual tests as well as on the test of study period averages. The absence of positive correlations between these variables means

that there is no evidence of profit advantages in gearing for this sample. The evidence before us, however, does not provide any explanation as to why positive correlations should be absent on these tests. One possible explanation that needs to be checked is that the cost of debt is so high as to negate advantages of the tax shield. Commercial bank interest rates in the study period are, however, reported(203,1974) to have averaged at a little over 10%, which is about the same as average RTO for the period. At the rates of tax obtaining in the study period, interest rates which are about the same as RTO are compatible with positive correlations between RTO and LS, and hence this explanation has to be rejected. Another possible explanation which cannot be disproved, however, is that borrowing is an alternative to internally generated funds (arising mainly from profits) and hence would lead to negative correlations between profitability and gearing. As conceded elsewhere in this chapter both profitability and gearing are likely to be influenced by many other variables as well, and therefore the results observed permit no more than a tentative conclusion that at the levels of gearing present in the sample, differentials in tax-shield are not large enough to influence profit levels.

Negative correlations are observed between the measure of gearing (LS) and tax charges in accounts (TX), though on the annual tests most of these correlations are not statistically significant. Nevertheless, the presence of negative correlations between these two variables is *prima facie* supportive of the position of survey respondents that tax considerations in financing decisions have more to do with the impact of taxation on debt-servicing ability rather than with the tax-shield on debt.

Significant negative correlations were observed also between the tax liability (TP) and other debt (LS). These correlations do, of course, reflect the fact that in double entry accounting tax payable and non-tax liabilities

together with ownership interest will equal total assets. Nevertheless these highly significant correlations indicate that the level of total debt (i.e. tax payable plus non-tax liabilities) varies within fairly narrow limits among the sample. A natural consequence of such limits - whether externally imposed or internally determined - would be to reduce the capacity of a firm for non-tax borrowing, when the tax-debt is high.

Significant negative correlations were observed between the measure of gearing (LS) and the level of liquid funds (CI). CI was also positively correlated with both tax-related variables (TX and TP), which in turn showed a close positive correlation with each other. This set of correlations is rather more difficult to explain. However, one scenario which to some extent matches the survey findings supposes that a high proportion of end-year liquid funds are earmarked for payment of the tax-bill: hence the positive correlation between TP and CI. This would in turn explain the positive correlation between CI and TX as a secondary relationship reflecting the correlation of each with TP. The negative correlation between CI and LS would also be a secondary relationship arising from the operation of fairly narrow limits for the level of total debt. High taxation could, then, be said to inhibit other forms of borrowing.

LS, the level of non-tax liabilities, also showed several other notable correlations. These were all positive correlations and were observed with (a) level of debtors and (b) investment as measured by both additions to fixed assets and increases in total assets. The positive correlation with debtors (highly significant from year to year but not significant at the 0.1 level on average) probably reflects the fact that trade debtors are often financed by means of commercial bank credit. As regards the correlations of LS with the measures of investment: it was seen in the survey of SL business (in Chapter 4) that roughly half of all major investments by existing

business firms were financed by various forms of debt. The positive (though not very significant) correlations observed are therefore only to be expected.

Returning to the relationship between taxation and financing of business, the above results can be said to be broadly supportive of the findings of the survey of business opinion that taxation was, in general, an inhibitor of debt financing.

Dividend Policies of SL Public Companies

Theoretical discussion on the impact of taxation on dividend policy centres mainly around the issue of double taxation of distributed profits and its consequences for dividend policy and share valuation. SL public companies interviewed during the survey did not however appear to be much concerned about tax minimisation by means of appropriate dividend policy (see Chapter 4).

In any event, the available information in company accounts is not adequate for the investigation of this question, nor does it permit any meaningful analysis of any other effects of taxation on dividend policy. The analysis in this section will therefore be limited to the verification of one aspect of dividend policy said to be important to the public companies participating in the survey of SL business.

If dividend maintenance objectives are important to public companies, this fact should be reflected in a cross-sectional correlation test in the form of negative correlations between the proportion of earnings to ordinary capital distributed as dividends (DOE) and the earnings attributable to ordinary share capital (RTO). Table 10F summarises the relationship between these two variables in respect of study period averages as well as annual ratios.

Table 10F

Spearman's Rank Correlation Coefficients between Profits and Dividend Payout

A. For Average Ratios 1964-1974

Variables	N	Spearman's r	Level of Significance
DOE v RTO			
(i) All Firms	20	-0.37	0.06
(ii) Manufacturing and Engineering firms	14	-0.43	0.06
(iii) Firms not reporting losses	16	-0.41	0.06

B. Summary of Annual Correlations

Variables	Total Number of correlations		Significant at level of 0.05 or better		Significant at level of 0.1 or better	
	+ve	-ve	+ve	-ve	+ve	-ve
DOE v RTO						
(i) All Firms	1	10	-	7	-	10
(ii) Manufacturing and Engineering firms	-	11	-	4	-	5
(iii) Firms not reporting losses	1	10	-	8	-	10

Details of the annual correlations summarised in Table 10F are to be found in Appendices 17.3-17.13. Results of a Pearsonian correlation test supporting the findings of the non-parametric tests on average ratios is given in Appendix 17.14.

The results in Table 10F show significant negative correlations between DOE and RTO. The presence of such negative correlations can be interpreted as confirmation of the survey findings that dividend maintenance is an important objective to SL public companies.

Conclusions

The main conclusions of the analysis of accounting ratios of SL companies are summarised below:

1. Changes in the rate of income tax may not be fully reflected in accounting provisions for taxation in the short-term.

2. There appears to be at least some tax-shifting among SL firms both in the short-term and in the long-term; though the practice of shifting may have become more difficult in later years.

3. The level of investment by companies does not show a significant relationship with the level of taxation - thus supporting the findings of the SL surveys that taxation was not a major inhibitor of corporate growth.

4. There is no indication that tax-shield advantages of financial gearing influence returns to equity to any great extent: but gearing levels are negatively correlated with the level of taxation, lending some support to the views expressed in the SL survey that high taxation tended to reduce borrowing capacity.

5. The finding of the SL survey that dividend maintenance objectives were important to public companies is confirmed by the ratio analysis.

CHAPTER 11.

SOME CONCLUSIONS

This chapter returns to the questions raised at the end of Chapter 1 and attempts to provide some answers to those questions in the light of the research findings. It is not intended to summarise here all the results and conclusions reported in earlier chapters. Rather, what follows will be a general discussion of the main research results, and their implications without necessarily going into qualifications and research problems discussed previously.

Perceptions of and attitudes to taxation

Are similar perceptions of and attitudes to taxation widely shared among various participants in business activity?

This question was raised at the end of the review of the literature in Chapter 1 and judging by the findings of this study, the answer to it must be - no. The mere observation of some diversity of perceptions of taxation would not be particularly remarkable in itself, but what is notable is that the perceptions of taxation (as well as of other environmental variables impinging upon business performance) appear to be systematically related to some organisational characteristics within the firms. For instance, among SL firms, it was seen (Chapter 3) that newer and smaller firms were less sensitive to environmental constraints than older and larger firms. Also, firms adopting profit maximisation as the main objective are more sensitive to taxation as a constraint than are firms with the main goal of maintaining a going concern. Owner-managers appear to be more sensitive to taxation and tax incentives

than professional managers; and firms growing at a very slow rate are more sensitive to environmental constraints (including taxation) than are those achieving high growth or no growth at all.

It was reported in Chapter 1 that studies on developed countries had found that perceptions of taxpayers regarding taxation could influence their behaviour, but no theories are offered in the literature as to the manner in which such perceptions are formed. The survey of SL business firms conducted as part of this study (Chapters 3 & 4) throws some light on this issue: the results indicate that differences in perceptions regarding taxation and other environmental variables among business firms operating in the same environment are associated with and could very well be influenced by organisational characteristics internal to the firms themselves.

Perceptions in regard to environmental influences were also seen to differ as between the three developing countries studied - SL, Malaysia and the Philippines. Import controls were perceived as the main constraint on SL business, whereas market limitations headed the list of constraints in the other two countries. Though tax incentives for investment were seen by business firms in all three countries as the most useful form of incentive offered by their respective governments, differences of opinion did emerge as to the relative usefulness of the two main types of tax incentive. Most divergences in perception were, however, attributable to differences in the business environments or the tax regimes among the countries.

Perceptions of taxation in SL differed also as between business firms and their professional advisors (Chapter 5). These differences in perception between groups subject to the same tax regime appear to a large extent to stem from their different roles in business activity. Predictably, professional observers tend to concentrate on tax effects observable from outside the business organisations. For instance, in attributing reasons for taxation

being a constraint on the achievement of business objectives, the firms themselves referred to business turnover tax as the most burdensome tax whereas professional observers believed that direct income taxes were the main constraint. This divergence in perceptions may very well arise from the fact that indirect taxes, however high the financial burden associated with them, rarely give rise to administrative or computational problems on the scale that is normal with direct taxes. It is with the latter, therefore, that most professional advisors and tax assessors will be concerned.

Further differences of opinion were observed between business managers and professional persons in SL concerning the variety of investment incentives offered in SL through the tax system and via other means. For example, professional observers believed that tax holidays had been a much more effective incentive than accelerated depreciation in promoting increased investment. On the other hand, business managers have found accelerated depreciation allowances to be the most widely useful incentive offered to date within or outside the tax system. That tax holidays have led to new investment in preferred activities is indisputable, but the evidence here is that the role played by accelerated capital allowances in promoting replacement investment appears to be undervalued by professional observers. The consequence of these perceptions on the part of persons outside business firms appears to have been a number of attempts over the past decade to remove the benefits of accelerated capital allowances. The scheme for granting capital allowances in SL has finally been completely withdrawn as from 1981: an investigation into the effects, if any, of this action is an interesting subject for future study.

In a minor experiment carried out within one firm, variations in perceptions were also observed between persons within the same organisation. The differences in perceptions which appeared to be related to the role of

the individual in the organisation were greatest, in regard to taxation, between the firm's tax manager and other managers. His involvement in tax matters appeared to have heightened the sensitivity to taxation of the tax manager.

In general, therefore, it is possible to conclude that many perceptions relating to taxation and other environmental influences are systematically related to organisational characteristics as well as to the role of the individual in business activity.

The surveys also revealed that perceptions of survey participants as to the severity of taxation were formed with reference to their past tax experience; and if this experience was in a single tax jurisdiction, no comparisons were usually made with tax regimes in other countries. This is not a surprising result given the general immobility of business organisations, whether due to governmental controls or societal pressures or other reasons. But it does have implications for fiscal policy makers in that any new tax measures will be judged by taxpayers not with reference to international tax levels but against their own past local tax experience.

Effects of taxation

Is the manner in which taxation is incorporated in decisions of business consistent with rational economic decision making as envisaged in economic theory, and what effects does taxation have on business decisions of LDC firms?

As regards investment decisions, the prediction in theory is that investment is reduced by the introduction of a tax or an increase in an existing tax and encouraged by tax incentives for investment which counter the effects of taxes. Empirical evidence in the literature (Chapter 1) is generally supportive of theoretical expectations but the effects of taxation and tax incentives on investment are not always found to be significant. Evidence

on SL gathered in this study (Chapters 3 & 4) points to the usefulness of tax incentives, but taxation is by no means a limiting factor on investment.

Though some SL managers believe themselves to be constrained by taxation in the achievement of their objectives, most firms do not appear to have taxation-imposed limitations on growth. Only a small minority of managers believed that taxation had hampered growth in their firms and specific investment plans were generally not adversely affected by taxation. Furthermore, high growth firms in SL were less constrained by taxation than the slow-growing, indicating possible influence of tax incentives in reducing the tax burden of a growing firm.

The analysis of company accounts (Chapter 10), however, does not show any strong systematic relationship between taxation charges in company accounts and corporate growth. Nevertheless, business managers are emphatic in their view that tax incentives have been very useful to them. They are particularly appreciative of the cash flow benefits that arise from accelerated capital allowances.

Yet, the dominant constraint on business activity in SL in the period studied was import control. In a market which was well protected against competing foreign goods by import control, and which was characterised by high demand and scarce supply of goods, profitability was largely a function of level of activity. The level of activity was in turn dependent on the availability of import permits. In the presence of this limiting factor, taxation and hence tax incentives were a secondary consideration. In the circumstances, one side effect of tax holidays which have enhanced their value to business, has been the fact that approval for tax holidays was usually accompanied by relaxation of import controls for the organisations concerned at least for some time.

Though it is clear that taxation was not a major constraint in SL on account of the presence of another more burdensome problem - import control - which was the major limiting factor on business activity, the presence of a less stringent regime of import control does not necessarily mean that the burden of tax as perceived by business managers is enhanced. As seen in the surveys of Malaysia and the Philippines, where import controls are not the major constraint, the position of prime limiting factor appears to be taken by market considerations (Chapter 5).

Another expectation generated by theoretical analysis of investment decisions (Chapter 1) is that the decisions may be influenced by the technique of investment appraisal used, partly at least on account of differences in treatment of taxation.

Among SL business, it was possible to see (Chapter 4) some influence of the technique of appraisal on the type of investment undertaken, but the levels of growth achieved by individual firms appear to be unaffected by the technique of appraisal used: growth rates of users of RCE are no different to those of firms using the more sophisticated discounted cash flow techniques.

Nor did the treatment of taxation in investment appraisals have any influence on the level of growth. Firms taking a very short-term view of taxation and apparently planning for short horizons did not suffer in their growth achievement as a result. The use of short planning horizons might well be a reaction to a relatively uncertain external environment. But the absence of a systematic relationship between level of growth and level of sophistication of investment appraisal technique reflects the state of the investment climate in SL, wherein the limits to growth are set by the lack of technically and commercially feasible investment proposals which will not be hampered by governmental controls. Under such circumstances what matters is the firm's ability to obtain preferred status for its activities:

differences between appraisal methods which may affect marginal investment decisions have little impact.

On the financing decisions of SL firms too, the influence of taxation is minimal. Other considerations, particularly the relative access to different forms of finance and owners' control requirements, appear to be more important in the formulation of financing policies.

Only a minority of the SL firms surveyed found tax considerations to be relevant in financing decisions (Chapter 4). Even among these firms, the main aspect of taxation considered relevant was its impact on debt-servicing capacity (or its liquidity effects) rather than the advantages of tax-shield on gearing. The analysis of company accounts (Chapter 10) provides support for the survey findings. Ratio analysis disclosed no profit advantages to equity following increased gearing. Instead, negative correlations were found between taxation and the level of debt, thus lending support to the survey findings that taxation inhibited borrowing and also indicating the maintenance by SL firms of fairly narrow limits to the level of total debt (ie. borrowing and tax debt).

Turning next to dividend decisions, theoretical predictions are that under a fiscal system which charges dividends to tax differently from retained earnings, taxation considerations should influence the proportion of earnings distributed. Empirical evidence on the question in developed countries, however, is inconclusive (Chapter 2).

The survey evidence on SL (Chapter 4) discloses that the majority of business managers believe tax considerations to be relevant in making decisions relating to distribution of profits: but liquidity considerations and dividend maintenance considerations are relatively more important.

Though some closely controlled family firms evidently chose their profit distribution policies to minimise taxes jointly for the firm and owner-managers,

tax-minimisation via dividend policy was not a universally important consideration. The impact of taxation on liquid resources available for distribution was the aspect of taxation considered relevant by most firms.

On the whole, taxation was not perceived by business managers as having any great influence on the above three areas of business decision-making. Even when tax considerations were relevant in decision-making, the manner in which tax inputs enter decision processes was not wholly consistent with the primacy of present-value or profit maximising objectives which underpin much of the theoretical analysis of the effects of taxation. Instead, liquidity considerations and the impact of taxation on liquidity, which are factors not usually emphasised in the literature, appear to be at least as prominent.

Pricing decisions are another area of business decisions where available empirical evidence in developed countries does not lead to definite conclusions about the treatment of taxation (Chapter 1). The survey evidence on SL (Chapter 4) indicates that BTT and other indirect taxes are seen by business managers as part of costs to be recovered in prices, whereas income taxes are viewed as being provided for by the mark-up in cost-plus pricing. *Prima facie* this treatment implies that business firms will attempt short term shifting of indirect taxes, but not income taxes. The analysis of company accounts (Chapter 10), however, provides a possible explanation for the difference. The analysis reveals that a change in the statutory rate of corporation income tax could take more than a year to work its way through into company accounts and possibly even longer to influence tax cash flows. There is strong likelihood that here again the difference between the treatment of direct and indirect taxes is related to the liquidity effects of the two types of tax. The former, taking more than a year (and possibly several years) to have any impact on cash flows, is not a consideration in short term pricing decisions, whereas indirect taxes which have a more immediate impact

on cash flows enter into pricing decisions even in the short term. Ratio analysis of company accounts suggests that business firms do attempt to shift even the income-tax by the time its impact is felt on the firm's reported profits, though such shifting appears to have become more difficult during the era of extended price controls in the 1970s.

Another area of decision making, that relating to the legal form of the business entity organisation, also appears to be largely uninfluenced by taxation. The reason again is that other considerations are relatively more important.

All in all, the empirical evidence in SL, supported by the restricted studies of Malaysian and Philippine business, is indicative of a not very decisive influence of taxation on business decisions. The limited influence it has is seen to be related in most cases to short-term liquidity issues. The evidence in the present study, however, does not permit us to say whether the prominence of liquidity considerations is a typically LDC phenomenon (arising from the greater imperfection of capital markets in these countries) or whether similar responses to taxation are to be found also in more developed economies.

The insignificance of the influence of taxation on business decisions relative to theoretical expectations is, in most cases, traceable to the existence of other limiting factors. This exposes a major weakness in theoretical analysis which is usually conducted under assumed conditions of *ceteris paribus*. Where one or more other factors exert more restrictive influences than taxation so as to become limiting factors on any business decision, then the analysis of tax effects assuming that all other conditions remain equal and hence irrelevant, may not lead to realistic predictions.

Viewing the response of business to taxation more generally, in their operations planning business firms may include taxes as an outgoing in routine

budgets or treat taxation as an item requiring special planning for minimisation, or both. By and large, SL firms are seen (Chapter 4) to adopt one or the other of these methods.

The differences in treatment of taxation are also seen to be associated with differences in perceptions of tax constraints. Those who are more sensitive to taxation appear to carry out special tax planning, whereas routine budgeting for tax is associated with lower sensitivity to taxation constraints. This provides another example of a relationship between taxpayer perceptions and behaviour, but no evidence is available as to which is cause and which is effect.

In another example of taxpayer behaviour (Chapter 9), pressure group activity was seen to be related to the attitude of society (and its political leaders) to the tax-paying sector. The indications are that the level of pressure group activity is related not so much to level of taxpayer education as implied in the literature, but more to the level of social hostility to the business sector.

Multinational corporations in LDCs

Next, with particular reference to multinational business in LDCs, we have posed the question - are tax conditions and business responses any different between developed countries and LDCs?

This study discloses (Chapter 8) that the performance of multinational firms in LDCs is subject to external influences to a greater extent than in developed countries. These external influences originate mostly in governmental action of one sort or another, but taxation is not a very common cause for concern. In developed economies, by contrast, commercial factors, especially market considerations, are of primary importance.

The reaction of MNCs (Chapter 7) to direct taxes as opposed to indirect was very similar to that of SL firms. Indirect taxes caused more problems for MNC firms than direct taxes: the former were also more directly relevant to pricing decisions.

MNC managers were on the whole more aware of the impact of taxation on business decisions (Chapter 7), and this might well be in consequence of the fact that their organisations operate under many different tax regimes, so that the influence of taxation is variable with location. Nevertheless, taxation or tax incentives were not factors that had a major influence on decisions relating to the location of MNC operations. As was the case with LDC firms, the most common reason for taxation not being a major consideration is the presence of other more important limiting factors. Access to LDC markets, which is often conditional upon local manufacture, is perhaps the main factor attracting investment from most MNC firms, while access to LDC resources is important to some. Political uncertainty is the major problem faced by MNC managers in their operations in the third world.

Content analysis of annual reports of MNCs (Chapter 8) revealed that though taxation is not a major problem to these firms, it is certainly a greater irritant in LDCs than in more developed areas. This is not to say, however, that the total tax burden in LDCs is in fact greater; tax effort ratios are on average lower in these areas than in developed countries. In any case, MNCs appear to be able to earn higher profits in LDCs and therefore should be in a position to bear a higher burden of tax in these locations.

Perhaps the major factor which neutralises the effect of host country taxes and tax incentives on a MNC is the existence of taxation in the home country which (in the absence of special tax sparing agreements) will be charged on foreign income either at time of earning or on remittance. With operations being carried on across many tax frontiers, however, MNCs have

available to them far more opportunities for tax-planning than firms operating under a single tax jurisdiction. There is evidence that MNC managers are aware of these possibilities and do take advantage of them, though tax-minimisation remains a secondary consideration subordinate to market objectives.

Implications for fiscal policy

Some of the main implications for fiscal policy makers in LDCs, and particularly in SL, arising out of the findings of this research are summarised below.

Taxpayer response to taxation measures - whether they be new taxes, tax increases or incentives offered through the tax system - can be influenced by their perceptions. The perceptions of business firms were, in turn, seen to be influenced by organisational characteristics of the firms. The effectiveness of fiscal policy (both from the point of view of revenue and as a tool of economic management) can therefore be maximised by understanding and responding appropriately to differences in perceptions and likely behaviour between various taxpayer groups. Failure to recognise taxpayer perceptions, particularly in a system where there is no open dialogue between taxpayers and fiscal policy makers, leads to a danger of dysfunctional consequences of tax measures.

Though taxation does impose constraints on the activities of business firms, it is by no means a limiting factor. Other environmental factors, particularly various physical controls imposed by government, are the major constraints on business in LDCs. The encouragement of entrepreneurial activity in these areas will therefore need more than tax incentives. In many areas of business activity, special tax incentives may be unnecessary: all that is required may be the elimination of other bottlenecks to private

sector activity imposed by government. Tax incentives could, however, serve a useful function in displaying the commitment of government to promoting and assisting selected areas of business activity.

Low taxation or tax incentives are not in general an important reason for multinational firms investing in LDCs. Nor do high taxes seem to bother them very much, particularly as they appear to be able to earn high profits in less developed areas, and probably as taxes have to be paid in their home countries on all income including income from LDCs. In these circumstances, special tax incentives may be ineffective in attracting MNC investment to LDCs, and could well prove to be an unnecessary sacrifice of revenue by LDC governments.

In SL, there was a strong possibility that some of the negative perceptions regarding the tax system among business managers could be due to the lack of open dialogue between taxpayers and the authorities. Though personal channels of communication between some taxpayers and the authorities were found to be very effective in resolving problems for the persons concerned, this practice itself can contribute to negative perceptions regarding the tax system among other persons.

Moving outside the issue of taxation, a government intent on encouraging business development must be cognizant of the goals and attitudes of businessmen and the entrepreneurial potential of the various groups comprising the country's business sector. In SL, owner-managers of business were seen to be capable of higher growth achievement than professional managers. Yet such entrepreneurs do not receive any open encouragement from the government: on the contrary, SL society and its leaders are openly hostile to individual entrepreneurs. Again business firms adopting profit or similar task-maximising objectives were seen to grow faster than firms setting themselves survivalist

goals of maintaining going concerns. The former type of firm was, however, in a minority in SL. In contrast, firms in the other two LDCs studied overwhelmingly chose task-maximising objectives and also achieved higher average growth levels. It is very likely that the low priority placed on task-maximising objectives relative to survival in SL is the result of the greater hostility of the environment in which SL businesses operate, in comparison with Malaysian and Philippine firms. These findings imply a need for the authorities in SL to encourage development-oriented maximising objectives among its business sector and to take a more supportive attitude to the sections of society displaying entrepreneurial skills.

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Some International Comparisons of Statistics relating to the Economy and the People

	SRI LANKA	Malaysia	Philippines	Nigeria	Zambia	Source	Remarks
Surface area (km^2)	65,610	329,749	300,000	923,768	752,614	*	
Population ('000)	13,730	12,300	43,751	64,750	5,138	*	1976 Mid-year estimates
Population density (per km^2)	209	37	146	70	7	*	World average = 30
Illiteracy (%)	22.4 (1971)	West 41.5 Sabah 56.0 Sarawak 65.0 (1970)	17.4	84.6 (1962)	52.7 (1969)	**	In Age Group 15+
Male expectancy of life at birth (yrs)	64.8 (1967)	West 65 East 50 (1974)	56.9 (1975)	37.2 (1966)	42.9 (1975)	*	
Unemployment ('000)	547.2	118.5	818.0	19.0	12.4	***	Zambia in 1975, others in 1976.
Percentage of total population unemployed (%)	4.0	1.0	1.9	0.03	0.24		
Per Capita National Income (U.S. $)	250	780	371	130	391	*	At market prices, in 1975. (1970 for Nigeria)
Average annual rate of growth of Gross Domestic Product.(%)		N.A.				*	At constant prices
(Period 1 - years)	(1963-70)		(1960-70)	(1960-66)	(1965-70)		
Total	5.0		5.1	4.4	2.4		
Per Capita	3.0		2.1	1.8	0.0		
(Period 2 - years)	(1970-76)		(1970-76)	(1970-75)	(1970-75)		
Total	4.7		6.3	5.1	3.3		
Per Capita	3.0		3.3	2.3	-0.2		

Sources:
- * United Nations Statistical Year Book 1977 and 1978 : New York 1978
- ** U N E S O Statistical Year Book 1978 : Paris 1978
- *** Year Book of Labour Statistics 1979 : ILO : Geneva : 1979.

Revenue of the Government of Sri Lanka

Rs million	1964/65	1965/66	1966/67	1967/68	1968/69	1969/70	1970/71	1971/72*	1973	1974	1975	1976	1977
Taxes on Production and Expenditure													
B T T	34.8	39.1	72.2	79.2	111.0	247.4	326.2	394.4	535.8	703.7	645.6	711.4	662.1
Selective Sales Taxes	190.7	175.9	202.4	242.1	280.4	267.6	302.3	380.9	407.7	749.6	831.2	918.4	1407.1
Import Levies	435.9	476.9	544.3	514.0	460.2	306.5	282.2	258.3	222.0	277.3	335.9	475.9	517.9
Export Levies	250.2	218.9	182.8	262.9	300.3	327.2	265.9	233.5	386.4	660.1	429.9	420.8	620.1
F E E Cs	-	-	-	77.0	285.2	466.0	395.8	536.1	673.7	964.1	1054.8	1073.5	1156.7
Other**	N.A.	N.A.	N.A.	N.A.	171.7	195.1	219.7	381.0	338.8	111.3	125.3	130.8	140.0
Income Tax	295.3	281.2	311.8	319.5	347.0	444.6	447.2	452.9	699.9	588.9			
Corporate											512.0	681.9	649.8
Non Corporate											258.0	253.6	286.7
Capital Taxes	27.4	23.4	22.5	23.3	28.7	29.2	39.7	34.7	54.9	47.9	65.2	59.5	68.4
TOTAL TAX REVENUE	N.A.	N.A.	N.A.	N.A.	1984.5	2283.6	2279.0	2671.6	3319.1	4102.9	4257.9	4725.8	5507.6
TOTAL GOVERNMENT REVENUE	1816.8	1877.6	1954.8	2202.1	2536.0	2736.7	2817.7	3300.5	4036.6	4863.3	5092.6	5749.9	6691.1

Notes:

1. Compiled from the State Accounts of the Republic of Sri Lanka.
2. * 12 month equivalent of 15 months ended 31.12.1972.
3. ** Includes Licence Fees, Stamp duty and sale of arrak and foodstuffs.

Appendix 1.2

Appendix 1.3

Revenue of the Government of Sri Lanka

Some Comparative Statistics

Year	1968/69	1969/70	....	1976	1977
Ratio of Government Revenue to GNP	24.1	22.1		20.4	19.3
Ratio of Taxation to Government Revenue	78.3	83.5		82.2	82.3

Common-Size Statement of Tax Revenue

Taxes on Production and Expenditure					
BTT	5.6	10.8		15.1	12.0
Selective Sales Taxes	14.1	11.7		19.4	25.5
Import Levies	23.2	13.4		10.1	9.4
Export Levies	15.1	14.3		8.9	11.3
FEECs	14.4	20.4		22.7	21.0
Other	8.7	8.5		2.8	2.5
	81.1	79.1		79.0	81.7
Income Taxes	17.5	19.5		19.8	17.0
Capital Taxes	1.4	1.3		1.3	1.2
	100.0	100.0		100.0	100.0

Notes:

1. Compiled from Reports of the Central Bank and the State Accounts of Sri Lanka.

2. Differences in totals are due to rounding of figures.

Appendix 1.4

Estimates of Number of Taxpayers

(Per assessments made* - excluding additional assessments)

Year	Resident Individuals	Non-Resident Individuals	Resident Companies	People's+ Companies	Non-Resident Companies
1957/58	50,281	1,753	1,040		542
⋮					
1964/65	88,730	2,137	378		271
1965/66	84,625	1,614	994		506
1966/67	86,574	1,994	767		372
1967/68	119,120	2,140	900		372
1968/69	94,139	2,036	998		315
1969/70	134,588**	1,821**	787		216
1970/71	160,799**	2,424**	1,023**		267**
1971/72	93,274	1,625	1,792**		360**
1972/73	47,310***	942	877		185
1973/74	30,002	683	620		80
1974/75	34,289	935	883		110
1975/76	37,175	1,142	921		40
1976/77	23,803	819	775	5	95
1977/78	29,521	995	688	2	69
1977/78 as percentage of 1957/58.	58.7	56.8	66.3		12.7

Notes:

1. Source : Annual Reports of the Commissioner of Inland Revenue of Sri Lanka.

2. * Variations in number of tax payers recorded from year to year are due to administrative delays in the issue of assessments.

3. ** "These were years of exceptional activity when the backlog of assessments due were cleared, prior to the introduction of the self-assessment scheme" -

   per Assessor, Statistical Division, Department of Inland Revenue, at personal interview.

4. *** The reduction in the number of taxpayers from 1971/72 to 1972/73 is partly due to the requirement that individual taxpayers making PAYE payments and earning less than Rs 12,000 p.a. need not submit assessments.

5. + Peoples' companies are resident public Limited companies with broad-based ownership; a new category of taxpayer created in 1975.

Index of Income Assessed (excluding additional assessments)

Year	Resident Individuals	Non-Resident Individuals	Resident Companies	Non-Resident Companies
	Rupees '000			
1957/58	604,894	23,556	156,285	153,044
	Index			
1957/58	100	100	100	100
⋮				
1964/65	152.8	91.0	53.3	0.60
1965/66	152.0	79.2	175.9	0.97
1966/67	155.3	88.7	141.3	0.67
1967/68	213.9	100.7	127.7	0.51
1968/69	174.5	86.8	194.5	0.60
1969/70	242.5**	85.3**	249.2	0.48
1970/71	320.7**	113.4**	268.2**	0.75**
1971/72	231.7	101.7	358.7**	0.75**
1972/73	140.2	91.8	132.2	0.44
1973/74	88.2	35.7	198.0	0.27
1974/75	109.2	53.6	198.8	0.35
1975/76	127.1	68.2	234.0	0.33
1976/77	98.4	52.4	196.0	0.30
1977/78	135.2	86.4	220.5	0.19

Notes:

1. Source: Annual Reports of the Commissioner of Inland Revenue; SL.

2. ** as for Appendix 1.4.

Appendix 1.6

Income Tax in Arrear

Date	Rs ('000) Payable	Held-over pending settlement of appeals
30.9.58.	61,505	53,980
.		
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.		
30.9.65	119,323	45,024
30.9.66	135,834	69,218
30.9.67	185,516	91,784
30.9.68	261,773	105,833
30.9.69	264,009	143,873
30.9.70	298,800	173,028
30.9.71	392,154	198,949
30.9.72	NA	NA
31.12.73	436,674	186,793
31.12.74	476,419	158,453
31.12.75	432,612	139,391
31.12.76	405,093	114,927

Arrears as percentage of taxes collected in the preceding year

Date	Payable	Held-over	Total
30.9.65	40.4	15.2	55.6
31.12.76	43.3	12.3	55.6

Source: Annual Report of the Commissioner of Inland Revenue; SL.

Appendix 1.7

Appeals against Income Tax Assessments

Year.	Lodged	Outstanding at the end of the year
1957/58	6,865	14,022
.		
.		
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.		
.		
1964/65	8.805	11,114
1965/66	8,584	15,402
1966/67	14,171	23,838
1967/68	19,239	24,060
1968/69	17,831	37,891
1969/70	21,491	45,632
1970/71	20,215	53,694
1971/72	25,381	57,080
1973	25,831	38,988
1974	10,887	29,981
1975	10,285	23,233
1976	9,312	18,547
1977	7,669	12,918

Number of appeals lodged as a percentage of estimated number of persons in four main classes (Appendix 1.4) of taxpayer.

1964/65	9.6%
1976	30.0%

Source: Annual Report of the Commissioner of Inland Revenue; SL.

Appendix 1.8

Tax Amnesties

A. Amnesties Granted

Particulars	Year	Number of declarants	Amount Declared Rs'000
* Income Tax Amnesty	1964	72	20,342
Income Tax Amnesty	1965	596	138,210
* Foreign Exchange/Income Tax Amnesty	1970	43	6,181
Gems/Foreign Exchange/ Tax Amnesty	1973	NA	NA
* Income Tax Amnesty for Cash Holdings	1978	NA	30,000 approx.
Demonetisation	1970	NA	21,362

B. Sources of Tax-Evaded Income declared in the 1965 Amnesty

	Rs'000
Textiles	42,091
Hardware	17,550
Gems and jewellery	10,949
Motor spares	8,259
Illegal trade	7,903
Foodstuffs	7,134
Manufacture	6,812
Rent and Interest	6,488
Paper and books	5,242
Agriculture	1,794
Export	1,758
Professions	1,523
Mixed and other sources	20,707
	138,210

C. Disposal of tax-evaded income as declared in the 1965 Amnesty

		Rs'000
Holdings of,	Cash	66,108
	Stocks	40,045
	Debts	11,754
	Articles of value	6,580
Personal expenses		10,723
Other		3,000
		138,210

Source: * Deputy Commissioner of Investigations, Inland Revenue at personal interview.

Others: Annual Reports of the Commissioner of Inland Revenue.

Appendix 2

UNIVERSITY OF WARWICK

SCHOOL OF INDUSTRIAL AND BUSINESS STUDIES

Questionnaire to Business Firms in Developing Countries - Sri Lanka

The confidentiality of your answers to this questionnaire will be respected. No one outside the research team at the University of Warwick, School of Industrial and Business Studies will see the completed questionnaire. If however, you do not wish to divulge the name of your firm, you may prefer to leave question 1 unanswered.

Most questions can be answered with a tick (✓) in the appropriate box. If you wish to make any additional comments, please use the space below each question or that at the end of the questionnaire. If you have any queries on the administration of the survey in Sri Lanka, Mr. Chandra Jayaratne, (Telephone: Colombo 35594), will be able to help you.

We should be most grateful if you would please return the completed questionnaire as soon as possible. We enclose a stamped addressed envelope.

Thank you very much for helping us in our research project.

1. Name of Firm .....
(If your firm is one of a group of companies, please answer on the basis of the group, if you think this is more sensible)

2. Nature of Business.....
.....

3. Commencement of Business

Over 30 years ago	Between 10 & 30 years ago	Between 5 & 10 years ago	Less than 5 years ago

4. Form of Organisation

a. Public limited liability company ☐
b. Private limited liability company ☐
c. Individual Proprietorship ☐
d. Partnership ☐
e. Other (specify)..... ☐
.....

5. Is the chief executive of your firm, either

a. the proprietor, a partner, the major shareholder or a member of family of one of these ☐
or
b. any other person ☐

6. Number of full-time employees
(Part-time employees to count one-half full-time)

Less than 25	26 - 100	101 - 500	More than 500

7. Capital Employed
(value of total assets)

Under Rs. 100,000	Rs. 100,001 - 500,000	Rs. 500,001 - 2,500,000	Over Rs. 2,500,000

8. It is usual for business firms to have one or more objectives, even if these are not formally set out. The following are some of the more common objectives of business enterprises. What do you consider are the main objectives (up to three) of your organisation?

a. Maximising profits ☐
b. Maximising owners' wealth ☐
c. Maximising market share ☐
d. Maximising value added ☐
e. Maximising employee welfare ☐
f. Maintaining a going concern ☐
g. Other (specify) ..... ☐
h. ..... ☐
i. ..... ☐

9. If from the list in question 8, you had to pick the most important objective, which would you choose?

a	b	c	d	e	f	g	h	i

10. Would it be correct to say that taxation is or has been a problem area making it difficult for your firm to achieve its objectives Yes ☐ No ☐

11. If you answered Yes to question 10, would you say that taxation is a

Major problem area	Fairly important problem area	Minor problem area

12. Here are some other problem areas which often make it difficult for business managers to meet their objectives. Please tick those which you think cause you significant difficulty.

a. Import controls		e. Market limitations	
b. Price control regulations		f. Shortage of finance	
c. Shortage of technical or professional skills		g. Others (specify).....	
d. Labour relations		h.	

13. If you answered Yes to question 10, where do taxation problems stand in relation to those listed under question 12?

Compared with	Taxation is a		
	Less Important Problem	Equally Important Problem	More Important Problem
a. Import controls			
b. Price Control regulations			
c. Shortage of technical and professional skills			
d. Labour relations			
e. Market limitations			
f. Shortage of finance			
Others (if specified under question 12)			
g.....			
h.....			

14. Growth of business can be measured in terms of assets, employment, sales etc. Using whatever measure is convenient to you, would you say that your firm has grown in the past five years, by

More than 100%	50 - 100%	10 - 50%	Under 10%	Not at all

15. If your firm has not grown very much in the past five years, was taxation an important discouraging factor Yes ☐ No ☐

16. If the firm has grown in the past five years, has this been by

Expansion of old activities	Diversification into new areas

17. If you have grown by diversification,

a. Into what areas of activity have you diversified?.....

.....

b. Was taxation an important consideration in your decision to diversify into these activities?

Yes	For some Activities	No

18. If you have grown by expansion, were you influenced by taxation considerations Yes ☐ No ☐

19. If you answered Yes to question 18, was this because, at the time of the expansion,
    a. Tax conditions in your area of business continued to be good ☐
    b. Tax conditions in your area of business took a turn for the better ☐
    c. Tax conditions in other possible areas became much worse ☐

20. The following are some incentives offered by the Government for the promotion of private enterprise. Please tick those that you think have made a significant contribution to the growth of firms in your area of business
    a. Tax holidays ☐
    b. Lump sum depreciation and other accelerated depreciation allowances ☐
    c. Development Rebate on fixed assets ☐
    d. Other investments reliefs ☐
    e. Foreign Exchange Entitlement Certificates on exports ☐
    f. Convertible Rupees on exports ☐
    g. Cash subsidies ☐
    h. Guaranteed prices and State marketing services ☐
    i. Other (specify) ..... ☐
    j..... ☐

21. Which One or Two of these would you say have been the most useful for firms in your area of business?

a	b	c	d	e	f	g	h	i	j

22. Sources of finance other than owners' capital are used to different extents in different firms. (Owners' capital for the purpose of this question is defined to include all reserves and retained profits). In your firm's capital structure, is the contribution of other sources of finance
    a. Greater than owners' capital ☐
    b. About the same as owners' capital ☐
    c. Somewhat less than owners' capital ☐
    d. Much less than owners' capital ☐
    e. Negligible or nil ☐

23. Has taxation been a consideration in your general borrowing policy decisions Yes ☐ No ☐

24. The following are some factors which may be relevant in deciding whether to borrow or to use owners' finance. Would you say that any of these apply to your firm?

	Always	Sometimes	Never
a. It is quicker to borrow than obtain owners' capital			
b. Internally generated funds are usually adequate for the firm's needs			
c. It is policy to borrow as little as possible			
d. Collateral requirements of lenders are a major problem			
e. Interest rates are unacceptably high			
f. Borrowing is preferred to fresh equity in order to maintain owners' control			
g. Others (specify).....			
h.....			

25. Is taxation of the firm or its owners a relevant consideration in your distribution of earnings to proprietors? Yes ☐ No ☐

26. If you answered Yes to question 25, is taxation a

Very Important consideration	Somewhat Important consideration	Minor consideration

27. Here are some other factors which some firms may consider important in making 'distribution' decisions. Would you say that these were relevant to your firm?

	Important	Relevant but not Important	Irrelevant
a. Maintaining a steady level of distribution			
b. Maintaining the proportion of earnings distributed			
c. Availability of liquid funds			
d. Uncertainty of profit			
e. Income requirements of proprietors			
f. Re-investing as much of the profits as possible			
g. Other (specify).....			
h.....			

28. In your view, how does the tax burden at present for firms in your area of business compare with

	Much higher	Somewhat higher	About the same	A little lower	Much lower
a. Taxes 8 - 10 years ago					
b. Taxes 2 - 3 years ago					
c. Taxes expected 2 - 3 years from now					

29. Would you be willing, if necessary, to complete another questionnaire or to grant us an interview?

Yes ☐ No ☐

30. If you answered Yes to question 29, at what address may we write to you?

.....

.....

.....

THANK YOU FOR COMPLETING THIS QUESTIONNAIRE

Appendix 3.1

Main Activities of Respondent Firms

Activity	No. of firms
Manufacturing (including engineering services)	34
Tourism (and related)	5
Agriculture	4
Export merchanting	3
Financial	2
Trade (other than export)	2
Mixed activities	18*
Miscellaneous	3
Not stated	3
	74

* Includes 13 in manufacturing, 13 in trade, 10 in export merchanting and 4 in tourism.

Appendix 3.2

Classification of Responses by Age of Firm

Business Commenced	No. of firms
Over 30 years ago	32
Between 10 and 30 years ago	23
Between 5 and 10 years ago	14
Less than 5 years ago	4
Not stated	1
	74

Appendix 3.3

Form of Organisation

	No. of firms
Public limited liability company	31
Private limited liability company	35
Individual proprietorship	1
Partnership	4
Mixed	3
	74

Appendix 3.4

Management

The Chief executive is	No. of firms
The proprietor, a partner, the major shareholder or a member of family of one of these	52
Any other person	22
	74

Appendix 3.5

Size Classification of Respondent Firms

Total Assets	No. of firms
Less than Rs 100,000	4
Rs 100,001 to Rs 500,000	10
Rs 500,001 to Rs 2,500,000	22
More than Rs 2,500,000	38
	74

Appendix 3.6

Crosstabulation - Age v Origin of Firm

Age	Number of Multinationals	Total in Group	Multinationals as Percentage of Group
More than 30 years	8	32	25
10 - 30 "	1	23	4
5 - 10 "	1	14	7
Less than 5 "	0	4	0

Testing the null hypothesis that the proportion of multinational firms operating in SL amongst older (pre-independence) firms is not different to the proportion of multinational firms amongst newer (post-independence) firms;

Contingency Table

Type of firm	Multinationals	Others	Total
Age			
More than 30 years	8	24	32
Less than 30 years	2	39	41
	10	63	73

$\chi^2 = 6.16$ with 1 degree of freedom (d.f.)

∴ The null hypothesis is rejected at a 0.025 level of significance.

Appendix 3.7

Crosstabulation - Age v Diversification

Age	No. of firms in Mixed Activities	Total in Group	%age in mixed activities	%age in mixed activities if known multi-nationals are excluded from age group
More than 30 years	10	32	31	40
10 - 30 "	5	23	22	23
5 - 10 "	3	14	21	23
Less than 5 years	0	4	0	0
	18	73		

Testing the null hypothesis that the proportion of mixed activity firms is independent of age for the two age groups - post and pre-independence firms:

Activity / Age	Mixed Activity	Single Activity	Total
More than 30 years	10	22	32
Less than 30 years	8	33	41
	18	55	73

$\chi^2 = 1.33$ with 1 d.f.

The null hypothesis is rejected at 0.25 level of significance.

Appendix 3.8

Crosstabulation - Organisational Objectives v Form of Organisation

	Organisation / Main Objective	Public Ltd.Co.	Private Ltd.Co.	Individual Proprietorship	Parternship	Mixed*
A	Maximising Profits	9	13	0	0	2
B	" Owner's Wealth	0	1	0	2	0
C	" Market share	1	5	0	0	0
D	" Value added	1	1	0	0	0
E	Growth	1	0	0	0	0
F	Maintaining a going concern	18	9	1	1	1
G	Other	0	3	0	0	0

Testing the null hypothesis that the choice of a task-related maximising objective as against a 'maintenance' objective is independent of form of organisation.

Contingency Table

Organisation / Main Objective	Public Ltd. Co.	Private Ownership	Total
Maximisation of profit or similar task-related measure (A to E above)	12	23	35
Maintaining a going concern (F)	18	11	29
	30	34	64

$$\chi^2 = 4.92 \text{ with } 1 \text{ d.f.}$$

∴ The null hypothesis is rejected at a 0.05 level of significance.

* One of the mixed ownership firms was privately owned while the other two were groups with both public and private ownership.

Crosstabulation - Most Important Objective v Type of Management

Management	Owners		Professional	
Most Important Objective	No. of firms	%	No. of firms	%
A. Maximising Profit	21	40	4	20
B. " Owners' Wealth	3	6	0	0
C. " Market share	6	11	0	0
D. " Value added	1	2	1	5
E. Growth	0	0	1	5
F. Maintaining a going concern	17	.33	13	65
G. Other	4	8	1	5
	52	100	20	100

1. Testing the null hypothesis that among the firms who choose the two most popular objectives, the choice of objective is independent of type of management.

Contingency Table

Management	Owner	Professional	Total
Most Important objective			
Maximising Profit (A)	21	4	25
Maintaining a going concern (F)	17	13	30
	38	17	55

$\chi^2 = 4.77$ with 1 d.f.

∴ The null hypothesis rejected at a 0.05 level of significance.

2. Testing the null hypothesis that the choice of profit maximisation or a task-related maximising objective similar to profit maximisation as against a 'maintenance' objective is independent of type of management.

Contingency Table

Management	Owner	Professional	Total
Most Important Objective			
Task-related maximising objective (A + B + C + D + E)	31	6	37
Maintenance objective (F)	17	13	30
	48	19	67

$\chi^2 = 6.00$ with 1 d.f.

∴ The null hypothesis is rejected at a 0.025 level of significance.

Appendix 3.10

Crosstabulation - Objectives v Management v Form of Organisation

Management and Organisation	Owner Managed		Professionally Managed	
Two most popular main objectives	Private firms	Public cos.	Private firms	Public cos.
A. Maximising Profit	12	7	1	2
B. Maintaining a going concern	6	8	3	10
A ÷ B	2.00	0.88	0.33	0.20

1. Testing the null hypothesis that among owner-managed firms privately owned firms are just as likely as Public limited companies to pick either of the above objectives;

Objective	Owner-Managed Private Firms	Owner-Managed Public Companies	Total
A. Maximising profit	12	7	19
B. Maintaining a going concern	6	8	14
	18	15	33

$\chi^2 = 1.34$

The null hypothesis is rejected at a 0.25 level of significance.

2. The expected frequencies among professionally-managed firms are too small to give significant results on the χ^2 test.

Appendix 3.11

Crosstabulation - Age v Type of Management

Age \ Management	Owner	Professional	Owner-managed firms as % of age group
More than 30 years	16	16	50
10 - 30 "	18	4	82
5 - 10 "	12	2	86
Less than 5 years	4	0	100

Testing the null hypothesis that the proportion of owner-managed firms to professionally managed firms is independent of age of firms;

Contingency Table

Age \ Management	Owner	Professional	Total
More than 30 years	16	16	32
Less than 30 years	34	6	40
	50	22	72

$$\chi^2 = 10.3 \text{ with } 1 \text{ d.f.}$$

The null hypothesis is rejected at a 0.005 level of significance.

Appendix 3.12

Crosstabulation - Form of Organisation v Type of Management

Management / Organisation	Owner	Professional	Owner-managed firms as % of group
Public Limited Company	16	16	50
Private Limited Company	29	6	83
Individual proprietorship	1	0	100
Partnership	4	0	100
Mixed form	2	1	67

Testing the null hypothesis that the type of management is independent of the organisation of the firm for public or private ownership;

Contingency Table

Management / Organisation	Owner	Professional	Total
Public Limited Company	16	16	32
Private company, or proprietory ownership	34	6	40
	50	22	72

$$\chi^2 = 9.35 \text{ with } 1 \text{ d.f.}$$

The null hypothesis is rejected at a 0.005 level of significance.

Appendix 3.13

Crosstabulation - Environmental Constraints v Size of Firm

Size (Capital Employed) / Environmental Factors	1 Less than Rs 100,000	2 Rs 100,000 -500,000	3 Rs 500,001 -2,500,000	4 Over Rs 2,500,000
Import controls	0	8	15	34
Taxation	1	6	12	21
Shortage of finance	3	4	12	16
Price Control	0	4	7	19
Market limitations	1	3	5	11
Shortage of skills	0	5	3	6
Labour relations	1	2	5	5
Number of firms in Size Class	4	10	22	38
* Index of sensitivity, I	1.5	3.2	2.7	2.9

Ranking of Constraints

Environmental Factors					In total
Import controls	5 eq.**	1	1	1	1
Taxation	2 eq.	2	2 eq.	2	2
Shortage of finance	1	4 eq.	2 eq.	4	3
Price control	5 eq.	4 eq.	4	3	4
Market limitations	2 eq.	6	5 eq.	5	5
Shortage of skills	5 eq.	3	6	6	6
Labour relations	2 eq.	7	5 eq.	7	7

$$* \quad I = \frac{\text{Total of all constraints affecting firms in class}}{\text{Number of firms in class}}$$

** eq.= equal ranking.

Appendix 3.14

Crosstabulation - Environmental constraints v Age of firm

Age of firm / Environmental Factors	1 less than 5 years	2 5-10 years	3 10-30 years	4 More than 30 years
Import controls	2	10	18	26
Taxation	1	8	13	17
Shortage of finance	3	7	9	15
Price control	1	6	10	12
Market limitations	0	4	7	9
Shortage of skills	1	1	5	6
Labour relations	1	2	4	6
Number of firms in Age Class	4	14	22	32
* Index of sensitivity, I	2.3	2.7	3.0	2.8

Ranking of Constraints

Environmental Factors					In Total
Import controls	2	1	1	1	1
Taxation	3 eq.	2	2	2	2
Shortage of finance	1	3	4	3	3
Price control	3 eq.	4	3	4	4
Market limitations	7	5	5	5	5
Shortage of skills	3 eq.	7	6	6 eq.	6
Labour relations	3 eq.	6	7	6 eq.	7

* I , as for appendix 3.13

Appendix 3.15

Crosstabulation - Environmental Constraints v Type of Management

Type of Management -	Owner	Professional
Environmental Factors		
Import controls	39	18
Taxation	30	10
Shortage of finance	29	6
Price control	19	11
Market limitations	12	8
Shortage of skills	10	4
Labour relations	9	4
Number of firms in Management Class	52	22
* Index of Sensitivity, I	2.8	2.8

Ranking of Constraints

Environmental Factors			In Total
Import controls	1	1	1
Taxation	2	3	2
Shortage of finance	3	5	3
Price control	4	2	4
Market limitations	5	4	5
Shortage of skills	6	6 eq.	6
Labour relations	7	6 eq.	7

Testing the null hypothesis that shortages of finance affect owner managed firms and professionally managed firms similarly:

Contingency Table

	Finance as a problem		
Management	Yes	No	Total
Owner	29	23	52
Professional	6	16	22
	35	39	74

$\chi^2 = 5.04$ with 1 d.f.

∴ The null hypothesis is rejected at a 0.025 level of significance.
Other differences between management types are not significant on the χ^2 test.

* I, as for Appendix 3.13.

Appendix 3.16

Crosstabulation - Environmental Constraints v Two most important objectives

Objective - Environmental Factors	Maximising Profits	Maintaining a Going Concern
Import controls	17	23
Taxation	17	15
Shortage of finance	15	14
Price control	12	13
Market limitations	9	8
Shortage of skills	3	7
Labour relations	6	5
Number of firms in 'Objective' Class	25	30
* Index of Sensitivity, I	3.2	2.8

Ranking of Constraints Environmental Factors			In Total
Import controls	1 eq.	1	1
Taxation	1 eq.	2	2
Shortage of finance	3	3	3
Price control	4	4	4
Market limitations	5	5	5
Shortage of skills	7	6	6
Labour relations	6	7	7

Testing the null hypothesis that the firm's choice of objective does not affect its sensitivity to taxation:

Contingency Table

Objective	Profit Maximisation	Going-concern maintenance	Total
Tax as a problem			
Yes	17	15	32
No	8	15	23
	25	30	55

$\chi^2 = 1.82$ with 1 d.f.

$\therefore$ The null hypothesis is rejected at a 0.25 level of significance.

* I as for Appendix 3.13.

Appendix 3.17

Crosstabulation - Management v Objectives v Perceptions of Taxation

A. Among Owner Managers

Taxation as a Problem	Yes	No	Total
Objective			
Profit Maximisation	15	6	21
'Going-concern' maintenance	7	10	17
	22	16	38

Testing the null hypothesis that among owner-managers, perceptions regarding the constraining effects of taxation are not influenced by choice of organisation objective;

On the above contingency table,

$$\chi^2 = 3.53 \text{ with } 1 \text{ d.f.}$$

The null hypothesis is rejected at a 0.1 level of significance.

B. Among Professional Managers

Taxation as a Problem	Yes	No	Total
Objective			
Profit Maximisation	2	2	4
'Going-concern' maintenance	8	5	13
	10	7	17

The expected cell frequencies here are too small to permit meaningful results on the χ^2 test: but observation of the above table shows no apparent difference between the two groups.

Appendix 3.18

Crosstabulation - Perceptions of Incentives v Type of Management

Most Useful Incentives	Types of Management - Owner	Professional
Tax Incentives		
Tax holidays	15	7
Lump-sum depreciation	31	8
Development rebate	12	2
Investment relief	2	0
Exchange Incentives		
FEECs	6	4
CRAs	7	6
Cash Subsidies	4	0
Guaranteed Prices & State Marketing	2	0
Other	2	0

Testing the null hypothesis that the appreciation of tax-incentives relative to exchange-incentives is unaffected by type of management:

Contingency Table

Management -	Owner	Professional	Total
Useful Incentives			
Tax-related	60	17	77
Exchange-related	13	10	23
	73	27	100

$\chi^2 = 4.12$ with 1 d.f.

The null hypothesis is rejected at a 0.05 level of significance.

Appendix 3.19

Crosstabulation of Perceptions - Incentives v Taxation as a Constraint

Taxation as a constraint -	Yes	No
Most Useful Incentives		
Tax Incentives		
Tax holidays	12	10
Lump-sum depreciation	26	13
Development rebate	12	2
Investment relief	1	1
Exchange Incentives		
FEECs	3	7
CRAs	5	8
Cash Subsidies	2	2
Guaranteed prices and State marketing	0	2
Other	0	2

Testing the null hypothesis that the appreciation of tax incentives relative to that of exchange-incentives is independent of perceptions of tax constraints on business:

Contingency Table

	Taxation as a Constraint		
Useful Incentives	Yes	No	Total
Tax-related	51	26	77
Exchange-related	8	15	23
	59	41	100

$\chi^2 = 7.29$ with 1 d.f.

$\therefore$ The null hypothesis is rejected at a 0.01 level of significance.

Appendix 3.20

Crosstabulation - (a) Environmental Constraints v Growth
(b) Incentives v Growth

Growth	1 Nil	2 Less than 10%	3 10%-50%	4 50%-100%	5 More than 100%
(a) Environmental Constraints					
Import controls	9	6	22	11	9
Taxation	5	7	12	10	6
Shortage of finance	2	5	13	7	8
Price control	4	5	13	3	5
Market limitations	5	2	7	1	5
Shortage of skills	3	6	4	2	3
Labour relations	2	2	5	2	2
Number of firms in Growth Class	11	8	28	13	14
* Index of Sensitivity, I	2.7	4.1	2.7	2.8	2.7
(b) Incentives					
Tax holidays	5	6	12	7	11
Lump-sum depreciation	8	8	23	11	13
Development rebate	5	6	16	8	12
Investment relief	1	5	4	4	5
FEECs	4	5	12	7	6
CRAs	5	6	15	8	7
Cash subsidies	2	2	2	2	1
Guaranteed prices and State marketing	0	2	3	0	0
Other	0	0	3	1	2
** Index of Sensitivity, I'	2.7	5.0	3.1	3.7	4.1

* I is as for Appendix 3.13

** $I' = \frac{\text{Total of all incentives listed by firms in class}}{\text{Number of firms in class}}$

Appendix 3.21

Crosstabulation - Growth v Management

Management	Owner	Professional
Growth		
A. N.L.	2	9
B. Less than 10%	6	2
C. 10-50%	21	7
D. 50-100%	10	3
E. More than 100%	13	1
	52	22

Regrouping growth levels as low (A + B), Medium (C) and high (D + E) and testing the null hypothesis that achievement of business growth is independent of type of management:

Contingency Table

Management	Owner	Professional	Total
Growth			
Low	8	11	19
Medium	21	7	28
High	23	4	27
	52	22	74

$$\chi^2 = 10.39 \text{ with } 2 \text{ d.f.}$$

The null hypothesis is rejected at a 0.01 level of confidence

Appendix 3.22

Index[1] of Growth of firms with reference to type of management.

Management	Owner	Professional
Age		
Less than 5 years	4	N[2]
5 - 10 "	3.3	1
10 - 30 "	3.7	1.7
More than 30 years	3.1	2.5

Notes

[1] $$\text{Index} = \frac{\sum_{i=1}^{5} (i \times \text{number of firms in } i^{th} \text{ Growth class})}{\text{Total number of firms in 'Age/owner' class}}$$

[2] N = No firms in 'Age/owner' class

[3] Growth class 5 = Growth > 100% :

" " 4 = Growth of 50-100% .....

.... " " 1 = Nil growth.

(See able 3F)

Appendix 3.23

Crosstabulation - Objectives v Growth

Growth -	1 Nil	2 Less than 10%	3 10%-50%	4 50%-100%	5 More than 100%
Most Important Objective					
A. Maximising profits	2	2	9	5	7
B. " Owner's wealth	0	1	2	0	0
C. " Market share	0	0	2	0	4
D. " Value added	0	0	1	1	0
E. " Growth	0	0	0	1	0
F. Maintaining a going concern	8	3	12	4	3
G. Other	0	1	1	1	0

Testing the null hypothesis that firms with the main objective of profit maximisation or the maximisation of a similar task-related objective are no different in their growth achievement from firms with the main objective of maintaining a going concern:

Contingency Table

Growth -	[1+2] Low	3 Medium	[4+5] High	Total
Objective				
Profit (or similar) maximising [A + B + C + D + E]	5	14	18	37
Maintaining a going concern [F]	11	12	7	30
	16	26	25	67

$\chi^2 = 6.61$ with 2 d.f.

∴ The null hypothesis is rejected at a 0.1 level of significance.

Appendix 3.24

Crosstabulation - Main Objective v Extreme growth classes v Management

Growth -	Nil		More than 100%	
Management -	Professional	Owner	Professional	Owner
Main Objective				
Maximising Profit (or similar)	2	0	0	11
Maintaining a going concern	6	2	1	2

Appendix 3.25

Crosstabulation - Management v Growth (among firms who have found taxation to be a constraint on growth)

Growth	Nil	Less than 10%	10-50%	50-100%	More than 100%	Total
Management						
A. Owner	1	5	6	3	-	15
B. Professional	2	0	1	0	-	3
						18

A : B = 5

Appendix 4.

A. Goals of Business Organisation - England (57)

Goal	Percentage of managers who consider goals to be of high importance
Organizational efficiency	81
High productivity	80
Profit maximisation	72
Employee Welfare	65
Organizational growth	60
Industrial leadership	58
Organizational stability	58
Social welfare	41

B. Aims of Management - Dent (42)

Aim	Percentage of managers listing aim	
	As first aim	In first three aims
To make money, profit or a living	36	52
To provide a good product; public service	21	39
To grow	12	17
To operate or develop the organization	9	14
To provide for the welfare of employees	5	39
To meet or stay ahead of competitors	5	13
To be efficient, economical	4	12
To pay dividends to stockholders	1	9
Miscellaneous	7	18
	100	

Appendix 5.

INVESTMENT INCENTIVES IN SL

CAPITAL ALLOWANCES

Two sorts of capital allowances were available in SL at the time of the survey, viz. Lump Sum Depreciation and Development Rebate.

Lump Sum Depreciation

Lump sum depreciation is a once-and-for-all lump sum allowance for depreciation granted in respect of depreciable assets in the year of acquisition of an asset. There were four rates of depreciation, as follows:

Short-lived equipment	80% of cost
Normal machinery	66 2/3% of cost
Durable machinery	50% of cost
Industrial buildings	33 1/3% of cost

The Department of Inland Revenue have issued detailed lists of assets falling under each of the above asset categories. Any asset not so classified will be placed in the appropriate category at the discretion of the assessor (subject of course to the usual appeal procedures). If income in any year is inadequate to set off lump sum depreciation allowances due in that year, any allowances not set off can be carried forward to subsequent years together with a premium of 4% per annum.

The rates of depreciation were changed in 1978 and the entire scheme is to be withdrawn in 1981.

Development Rebate

Development rebate is an additional capital allowance granted on the acquisition of fixed assets. The rebate is granted as a deduction in arriving at assessable income at the following rates:

Acquisition of new plant and machinery and construction of industrial buildings by an agricultural undertaking or an approved project	40%
For all other business, acquisition of plant and machinery at commencement and construction of industrial buildings at any time	20%

This rebate was merged with the lump sum depreciation allowance in 1978.

TAX HOLIDAYS

A variety of tax holidays for many different activities have been on offer during the study period. A brief account of these are given below:

1. Manufacturing industry - A 5 year tax holiday for firms commencing business between 1951 and 1972, subject to the fulfilment of several conditions regarding number of employees, source of capital etc. From 1969, this holiday was conditional upon prior approval of Ministry.

2. Deep sea fishing and undertakings carried on in land leased from the government - Tax holiday as for manufacturing industry for firms commencing business before 1968.

3. Operation or construction of tourist hotels - A complete tax holiday for 5 years and a partial (50%) tax holiday for 15 years subject to ministerial approval.

4. Export of non-traditional products -

   a) An 8 year holiday for approved exporters if business is carried on by a limited liability company incorporated after April 1972.

   b) A 5 year holiday on increased earnings of an approved export undertaking which increases its export of non-traditional products after April 1972.

5. Gem trade - Profits on export of gems and on sale of gems to the State Gem Corporation are exempt from April 1972.

6. Housing developers - Exemption of profits on construction of small houses from 1973.

Note: Dividends declared by tax holiday companies were exempt from income tax in full upto 1974. After that date, exemption was subject to a ceiling on distribution.

INVESTMENT RELIEF

Investment relief was a deduction from assessable income available to persons (companies and individuals) making investments in 'approved undertakings'. The deduction was of the entire value of the investment or a proportion specified in the Law. This relief was available between 1967 and 1973.

CONVERTIBLE RUPEE ACCOUNTS (CRAs)

Under the CRA scheme introduced in 1972, a percentage of foreign exchange earnings on export of non-traditional or minor export products and some services were permitted to be credited to a convertible rupee account.

A number of changes were made to the scheme from time to time - both in regard to the percentage of earnings to be credited to the accounts (varying between 2% and 25% of net f.o.b. earnings depending on the source of income) and in respect of the types of earnings entitled to CRA credit. In general, exporters with CRA credit could utilize such funds for foreign travel, and in paying for imports and overseas expenses of a non-capital nature, without being limited by the usual exchange and import controls.

FOREIGN EXCHANGE ENTITLEMENT CERTIFICATES (FEECs)

The FEEC scheme is the commonly used name of a dual exchange rate system in operation in SL from 1968. Under this scheme all earnings of foreign exchange from the export of goods and services other than the three major agricultural exports (viz. tea, rubber and coconut) were entitled to a premium on the official rate of exchange. Most imports into the country also came under the purview of this scheme and importers were likewise charged a premium on the official rate of exchange for foreign currency released to pay for such imports. This scheme underwent many changes during its life-time: the premium originally intended to be fixed by the interplay of market forces was within a few months of the introduction of the scheme converted to a fixed rate of 44%. At the time of the survey, the premium stood at 65%. Also from time to time, there were changes made to the types of transactions covered by the scheme.

CASH SUBSIDIES

Cash subsidies offered have been mainly to agricultural activities. The most important subsidies to the private sector have been given for

(a) replanting tea and rubber lands and (b) for the pur ase of fertilizer for rice growing.

GUARANTEED PRICE SCHEMES AND STATE MARKETING SERVICES

The most important scheme of Guaranteed prices/State marketing services has been operated in respect of rice-growing. As a service to peasant farmers and as an incentive for increased production of rice, the scheme offered local farmers prices well above that of imported rice.

Marketing assistance schemes have also been operated for other agricultu products (by the Marketing Board), for manufacturing industry (by the State Trading Corporation) and for dairy products (by the Milk Board).

Appendix 6

Investment Incentives favouring Limited Liability Companies

	Section of the Inland Revenue Act No. 4 of 1963		Provision
1.	7A	-	Provides for exemption of certain export profits of Limited liability companies after April 1, 1972.
2.	16C	-	Provides for allowances in respect of approved investments made prior to April 1973, to be deducted from the assessable income of individuals. An undertaking will be approved under this section only if it is a limited liability company.
3.	16CC	-	Allows investment relief on approved investments after April 1, 1973. The allowance is to any person (ie., a company or individual); but the investment must be made in a limited liability company.
4.	68A	-	Investment relief is allowed under this section only to limited liability companies and "bodies of persons". However parallel relief is available to individuals under section 69 of the Act.
5.	73A	-	15 years partial tax holiday for tourism is available only to limited liability companies.

Appendix 7

Taxation in Investment Appraisal

This appendix will examine the treatment of taxation in the investment appraisal techniques commonly used by SL business firms.

Accounting Return on Capital Employed (RCE) was the technique most commonly used by SL business firms surveyed. Discounted Cash Flow (DCF) techniques - net present value (NPV) or internal rate of return (IRR) - were used by a significant proportion of interviewees. The payback technique which was also in use, essentially as a subsidiary method, alongside RCE or DCF appraisal will not be discussed here.

RCE, whether used as a decision rule in investment appraisal or as an ex-post performance measure, can be defined in a number of different ways, as more than one meaning can be attached to both the numerator and the denominator of this ratio,[41,p.418] Investment returns reported on RCE would, therefore, be a function of the definition of RCE used, even if the issue of taxation is excluded.

Several SL firms taking part in the survey provided brief descriptions of their investment appraisal techniques. As far as can be ascertained from such descriptions, the definition of RCE used by these firms is 'the ratio of the return of a typical year to the initial capital investment'.

ie. $$RCE = \frac{R_t}{CE_1} \quad .... \quad \text{(Def. A)}$$

where R_t = net profit for the typical year

CE_1 = Initial capital employed.

The example below compares the results on the above definition with another possible interpretation of RCE, viz.

$$RCE = \frac{1}{n} \sum_{j=1}^{n} \left(\frac{R_j}{CE_j}\right) \quad ... \quad \text{(Def. B)}$$

where R = net profit for the jth year

CE = capital employed at the beginning of the jth year, and

n = project life in years.

Example 1.

Assume a capital investment in a depreciable asset. If the investment produces equal annual profits after straight-line depreciation and if tax-effects are ignored, RCE will be as follows:

Project life years	RCE on Def. A.	Def. B.
2	10	15
6	10	24.5
8	10	28.6
11	10	30.2
25	10	38.2

It is clear from the above example that the two definitions give different values of RCE and that the difference between results of the two methods is a function of project life. The disparity in ratios between different definitions of RCE is not merely a function of project life: patterns of profit flows and accounting conventions such as depreciation technique can also influence the ratios in different ways.

The deficiencies of RCE as an investment appraisal tool stemming from (a) problems of definition, (b) vagaries of accruals accounting valuation to which it is subject and (c) its inability to take into account the time-value of money are well documented.(193,p.48) Subject to these shortcomings, RCE can be calculated on post-tax figures of return, with no additional problems of taxation was levied as a percentage of book profits. However, under a tax regime incorporating accelerated depreciation allowances and tax holidays, there is no satisfying way in which taxation can be built into calculations of RCE, particularly on definition A referred to above. The interviewees attempted to get round this problem by accounting for tax as if it was a straight percentage levy on book profits and quite separately considering the cash flow benefits of accelerated capital allowances.

The discounted cash flow methods of investment evaluation overcome some of the disadvantages of RCE in being uninfluenced by accounting conventions and in their ability to take into account the time-value of money, though many controversial issues relating to matching of DCF evaluations with objectives of the organisation and appropriate discount rates are without agreement among academic writers.[190,Ch.5-8] Subject to these limitations, however, NPV and IRR - the two main DCF techniques - give the same accept/reject decision on the evaluation of a single project. But because of the differences in the substitution rate (or, as some authors call it, the reinvestment assumption) implicit in the two methods, they can produce different rankings when a choice has to be made between two or more projects; though incremental analysis can be carried out on IRR to produce the same ranking as on NPV. Both DCF techniques are equally capable of taking into account tax cash flows and of making due allowances for time lags expected in the payment of taxes.

The major computational problems related to taxation arise out of the interdependencies between the project being evaluated and other existing and future activities of the taxpaying organisation. Often, with large accelerated capital allowances falling due at the inception of a project, the profits generated by the project may not be adequate to absorb all available allowances as soon as the entitlement arises. In such circumstances, if the tax-payer has other taxable profits against which capital allowances of the new project can be absorbed, the earlier receipt of allowances (in terms of tax payments delayed) can increase their present value. The following example (example 2) illustrates the effect of variation in timing of lump-sum depreciation allowances on the DCF internal rate of return.

Example 2.

Assume an investment of Rs. 27,000 in a depreciable asset producing annual operating cash flows of Rs. 10,000 for six years. If the asset has

no salvage value at the end of its effective life and if income tax is chargeable at 50% on operating profits with a one-year time lag, and if lump-sum depreciation (LSD) of 80% is available on the asset, the following results are calculated:

	IRR
(a) If LSD can be claimed immediately against other profits	23%
(b) If LSD is claimed against profit from the project	19%
(c) If LSD is claimed against profits from the project, and development rebate is also available at 20%	21%

It can be seen that the ability to claim LSD on existing taxable profits makes a difference of 4% ((a)-(b)) to the IRR of the above investment. This means that an existing company already in a profit-making position would stand to gain more from lump-sum depreciation allowances than a new company commencing business with the investment or an existing loss-making company. This advantage to an existing firm vis-a-vis a new firm, is countered to a certain extent by the availability of development rebate which at commencement of business is allowed (at 20% or 40%) on all investment in depreciable fixed assets. It will be observed from (c) above, that the difference in IRR on the project between a new and an old company is only 2% ((a)-(c)) where development rebate is available at 20%. Nevertheless, the fact that project IRR is influenced by the current tax status of the firm remains unaltered.

A tax system that allows 100% initial capital allowances on an investment will leave the IRR of the investment unchanged from a pre-tax position and is therefore said to be neutral in respect of the investment decision.[158] Lump-sum depreciation allowances in SL are made at different rates - varying from 50-80% for Plant and Machinery and at $33\frac{1}{3}$% on buildings. The underlying rationale for these rates of LSD is a desire to attain equality between

assets of different lives. The rates are designed to give depreication of 100% of asset cost if LSD is compounded at a 4% rate of interest up to the end of the asset's useful life. It must also be noted that depreciation schedules are not very detailed and much approximation is accepted. For instance, plant and machinery are divided into three categories of asset life - viz. lives of 6, 11 and 18 years, and every item of plant and machinery should be allotted to one of these three categories. The department of inland revenue has issued lists of assets that fall into the different classes but any asset not included in the lists will be allocated to a class at the discretion of the assessor.

The attainment of end-of-life equality of depreciation allowances has the consequence that the tax system is slightly biased in favour of short-lived assets as seen in the following example.

Example 3.

Assume an investment in a depreciable asset producing equal annual operating cash flows. If LSD can be calimed immediately (against existing profits), if the asset has no residual value at the end of its life, and if taxation is levied at 50% payable one year in arrear, the following results are calculated:

		A	B
If pre-tax IRR	=	29%	15%
Post tax IRR,			
(a) for an asset of 6 year life	=	23%	9.5%
(b) for an asset of 11 year life	=	22%	9.3%
(c) for an asset of 18 year life	=	21%	8.8%

At all realistic rates of discount there will be a small bias in favour of short-lived assets if investment decisions are made on the basis of DCF evaluations.

Another investment incentive used widely in SL, the tax holiday (mostly

short-lived projects as illustrated below.

Example 4.

Assume an investment with a pre-tax IRR of 29% and equal annual operating cash-flows. If taxation is levied at 50% payable one year in arrear and a 5 year tax holiday is available, IRR of the project will be as follows:

Project Life years	IRR Pre-tax %	IRR Post-tax %
6	29	28
11	29	25
18	29	25

Finally, taxation with 100% initial capital allowances was said above to be neutral in that it would leave the IRR of investment unaffected. LSD in SL falls short of a 100% allowance and hence, IRR is reduced by taxation. However, the extent to which IRR is affected by taxation is much less for depreciable assets than for investments in working-capital or other non-depreciable assets. The relative positions are reversed: if the evaluation is carried out on RCE, as seen in the following illustration.

Example 5.

Assume an investment producing equal annual operating cash flows and a DCF return of 29%. If taxation is charged at 50% payable one year in arrear, the following results are calculated:

Project Life Yrs	Type of asset	Rate of LSD %	RCE on* initial capital employed %	IRR with LSD received immediately %
6	Plant and Machinery	80	10.2	23
11	"	$66\frac{2}{3}$	10.9	22
18	"	50	11.9	21
Any length	Working Capital	None	14.5	17

* With straight line depreciation

The above figures lead to the conclusion that

(a) RCE shows lower post-tax returns than DCF on all types of and lives of investment,

(b) whereas IRR on plant and machinery decreases with increasing asset life, the reverse is true of RCE. The differences between RCE for the range of asset lives considered are however not large.

(c) IRR evaluation will show lower post-tax returns on a working-capital investment (where the initial investment is held as circulating capital for the duration of the project and recouped in full at the end of its life) as against investment in plant and machinery whereas opposite is true of RCE.

It is therefore not unreasonable to expect that users of DCF evaluation methods will tend to favour investment in fixed assets relative to users of RCE. As diversifying investment is more likely to involve greater proportion of capital assets relative to working capital than expansionary investment (which might well be intended to increase utilisation of existing capacity), it is possible that the users of DCF evaluation techniques will tend to invest more in diversifying investment than users of RCE. This was indeed found to be true of the SL firms interviewed.

In summary, then,

(a) the treatment of taxation differs as between various methods of investment appraisal with the possible consequence of divergent project rankings,

(b) tax related project interdependencies have the consequence that an investment proposal cannot be evaluated in isolation: the investor's tax status on other activities can make a significant difference to the returns on an investment,

and (c) the main investment incentives offered in SL in the past two decades introduce an element of discrimination as between investments of difference lives.

Appendix 8.1

Crosstabulation - Technique of Investment Appraisal v Growth

Growth Class	1 Nil	2 less than 10%	3 10%-50%	4 50%-100%	5 More than 100%	Growth Index (GI)
Technique of Investment Appraisal						
RCE		1	1	4	2	3.9
RCE + Payback	3	2	2	1	3	2.9
DCF methods			4	1		3.2
DCF + Payback			1			3.0
Payback			1			3.0
All three			1			3.0
None			2	1		3.3

$$GI_j = \frac{\sum_{i=1}^{5} (i \times \text{Number of firms in } i^{th} \text{ growth class using } j^{th} \text{ technique})}{\text{Total number of firms using } j^{th} \text{ technique.}}$$

Appendix 8.2

Crosstabulation - Technique of investment Appraisal v Growth Strategy

Technique of Investment Appraisal / Growth Strategy	Expansion	Diversification	Both	Neither	Not known
RCE	5	1	2		
RCE + Payback	4	1	2	3	1
DCF	1	1	3		
DCF + Payback		1			
Payback			1		
All three	1				
None	1	1	1		

Regrouping firms which use RCE or DCF (with or without Payback criteria) and

(i) Testing the null hypothesis that the undertaking of diversifying investment is independent of whether RCE or DCF is used as the appraisal technique:

Contingency Table

Technique of Appraisal	Undertaking of Diversifying Investment: Yes	No	Total
RCE	6	9	15
DCF	5	1	6
	11	10	21

$\chi^2 = 3.23$ with 1 d.f.

$\therefore$ the null hypothesis is rejected at a 0.1 level of significance.

(ii) A similar test carried out for expansionary investment showed no significant difference between users of RCE and users of DCF.

Appendix 8.3

Crosstabulation - Factors relevant in Borrowing Policy Decisions v Level of Gearing

Level of Gearing	1	2	3	4	5
Factors Relevant in Borrowing Policy	Negligible or nil	Much less than owner's capital	Somewhat less than owner's capital	About the same as owner's capital	Greater than owner's capital
A. Quicker to borrow than to obtain equity	3	3	3	12	14
B. Need to maintain owner's control	3	9	4	8	16
C. Taxation	1	4	2	3	6
Number of firms in Gearing class	10	18	8	13	21

Regrouping the gearing classes as high geared (Classes 4 and 5 above) and low geared (Classes 1, 2 and 3 above), and testing the following null hypotheses:

(A) that the level of gearing is unaffected by the relevance in borrowing policy of ease of access to debt relative to equity:

Contingency Table

Easy Access to debt Relevant	Gearing	Low	High	Total
Yes		9	26	35
No		27	8	35
		36	34	70

$\chi^2 = 18.53$ with 1 d.f.

∴ The null hypothesis is rejected at a 0.005 level of significance.

(B) that the level of gearing is unaffected by the relevance of owners' control requirements in borrowing policy decisions:

Contingency Table

Owners' Control requirements relevant	Gearing - Low	High	Total
Yes	16	24	40
No	20	10	30
	36	34	70

$\chi^2 = 4.88$ with 1 d.f.

∴ The null hypothesis is rejected at a 0.05 level of significance.

(C) that the level of gearing is unaffected by the relevance of tax considerations in borrowing policy decisions:

Contingency Table

Tax considerations relevant	Gearing - Low	High	Total
Yes	7	9	16
No	29	25	54
	36	34	70

$\chi^2 = 0.49$ with 1 d.f.

∴ The null hypothesis cannot be rejected at a 0.25 level of significance.

Appendix 8.4

Crosstabulation - Factors Relevant in Distribution v Form of Organisation

Organisation	Public limited liability company	Private limited liability company
Factors relevant		
Taxation	18	20
Availability of liquid funds	25	25
Maintenance of a steady dividend	24	17
Income requirements of proprietors	9	13
Number of firms in Organisation class	31	35

Testing the null hypothesis that the maintenance of a steady stream of dividends is equally important to public companies and private companies:

$$\chi^2 = 5.81 \text{ with } 1 \text{ d.f.}$$

$\therefore$ the null hypothesis is rejected at a 0.025 level of significance.

The differences in relevance of other factors are not significant on the χ^2 test.

Appendix 8.5

Crosstabulation - Factors Relevant in Distribution Decisions v Management

Management -	Owner	Professional
Factors relevant		
Taxation	32	12
Availability of liquid funds	38	17
Maintenance of a steady dividend	26	19
Income requirements of proprietors	22	3
Number of firms in Management class	52	22

A. Testing the null hypothesis that the maintenance of a steady stream of dividends is equally important to owner-managed firms and professionally managed firms;

$$\chi^2 = 8.58 \text{ with } 1 \text{ d.f.}$$

$\therefore$ the null hypothesis is rejected at a 0.005 level of significance.

B. Testing the null hypothesis that the income requirements of proprietors are equally important to both types of management in making distribution decisions;

$$\chi^2 = 5.68 \text{ with } 1 \text{ d.f.}$$

$\therefore$ the null hypothesis is rejected at a 0.025 level of significance.

The differences in relevance of other factors are not significant on the χ^2 test.

Appendix 8.6

Crosstabulation - Perceptions of tax burden v Budgetary Practices

Preparation of tax inclusive annual budgets

Taxation as a constraint on achievement of objectives	Yes	No	Total
Yes	6	10	16
No	12	2	14
	18	12	30

Testing the null hypothesis that perceptions of taxation as a constraint are not related to whether or not tax inclusive annual budgets are prepared;

$\chi^2 = 7.23$ with 1 d.f.

$\therefore$ the null hypothesis is rejected at a 0.01 level of significance.

Appendix 8.7

Crosstabulation - Perceptions of Tax Burden v Determination of Product Prices

Taxation as a constraint on achievement of objectives	Determination of Product Prices: By Internal Cost[a] + pricing	By External Factors[x]	Total
Yes	9	5	14
No	4	3	7
	13	8	21

Testing the null hypothesis that business perceptions of taxation as a constraint are unrelated to whether product prices are internally or externally determined;

$\chi^2 = 0.10$ with 1 d.f.

$\therefore$ the null hypothesis cannot be rejected at a 0.25 level of significance.

a Cost = operating costs + indirect taxes.

x Market demand, Price control, Policy of State Corporations and Political factors.

Appendix 8.8

Crosstabulation - Perceptions of Tax Burden v Practice of Tax Planning

	Practice of Tax Planning		
Taxation as a Constraint on achievement of objectives	Yes	No	Total
Yes	14	2	16
No	8	6	14
	22	8	30

Testing the null hypothesis that business perceptions of taxation as a constraint are not related to whether tax planning is practised in the firm;

$\chi^2 = 3.52$ with 1 d.f.

$\therefore$ the null hypothesis is rejected at a 0.1 level of significance.

Appendix 9

UNIVERSITY OF WARWICK

SCHOOL OF INDUSTRIAL AND BUSINESS STUDIES

Questionnaire to Professional Persons in Developing Counrties - Sri Lanka

The confidentiality of your answers to this questionnaire will be respected. No one outside the research team at the University of Warwick, School of Industrial and Business Studies will see the completed questionnaire. If however, you do not wish to give your name, you may prefer to leave question 1 unanswered.

Most questions can be answered with a tick (✓) in the appropriate box. If you wish to make any additional comments, please use the space below each question or that at the end of the questionnaire. If you have any queries on the administration of the survey in Sri Lanka, Mr. Chandra Jayaratne, (Telephone: Colombo 35594), will be able to help you.

We should be most grateful if you would please return the completed questionnaire as soon as possible. We enclose a stamped addressed envelope.

Thank you very much for helping us in our research project.

1. Name.....

2. Occupation .....

3. From your experience of business activity in your country would you say that corporate or personal taxation has proved in the past to be a factor inhibiting business development? Yes ☐ No ☐

4. If you answered Yes to question 3, would you say that taxation is a

Major Constraint	Fairly Important Constraint	Minor Constraint

5. Here are some other problem areas that business managers think form significant constraints on business development. Do you agree?

a. Import controls		e. Market limitations	
b. Price control regulations		f. Shortage of finance	
c. Shortages of technical or professional skills		g. Others (specify).....	
d. Labour relations		h.....	

6. If you answered Yes to question 3, where in your opinion do taxation problems stand in relation to those listed in question 5.

Compared with	Taxation is a		
	More Important Problem	Equally Important Problem	Less Important Problem
a. Import controls			
b. Price control regulations			
c. Shortages of technical and professional skills			
d. Labour relations			
e. Market limitations			
f. Shortage of finance			
Others (if specified under question 5)			
g.			
h.			

7. The following are some incentives offered by the Government for the promotion of business enterprise in selected fields. What is your assessment of the contribution made by these to business development?

Question 7 continued:

	Major Contribution	Somewhat Important Contribution	Minor Contribution	Negligible or No Contribution
a. Tax holidays				
b. Lump sum depreciation and other accelerated depreciation allowances				
c. Development Rebate on fixed assets				
d. Other investment reliefs				
e. Foreign Exchange Entitlement Certificates on exports				
f. Convertible Rupees on exports				
g. Cash subsidies				
h. Guaranteed prices and State marketing services				
i. Other (specify).....				
j.				

8. Which two of these do you think have been most effective in encouraging business development .....
.....

9. Do you think in your country, tax considerations play a significant part in

	In all firms	In the majority of firms	In some firms	In a few firms	In no firm
a. Borrowing policy decisions of business firms					
b. Distribution of business profits to owners					

10. In your view, how does the tax burden at present on business in your country compare with

	Much higher	Somewhat higher	About the same	A little lower	Much lower
a. Taxes 8 - 10 years ago					
b. Taxes 2 - 3 years ago					
c. Taxes expected 2 - 3 years from now					

11. The following are some of the amendments to the Inland Revenue Act introduced by the Inland Revenue (Amendment) Law of 1976. In your opinion, what effect, if any, are these amendments likely to have on growth of business in Sri Lanka?

	Major Incentive	Minor Incentive	Neutral	Minor Disincentive	Major Disincentive	Other Comments if any
a. Exemption from income tax of travelling allowances received by an employee is withdrawn from the year of assessment 1975/76						
b. Exemption from income tax of an entertainment allowance received by an employee is withdrawn from the year of assessment 1975/76						
c. Earnings in foreign exchange in the course of any profession, vocation or employment, carried on or exercised abroad by a resident person, is exempt from income tax, with effect from the year of assessment 1976/77, provided such earnings less reasonable expenses are remitted to Sri Lanka						

Question 11 continued:

	Major Incentive	Minor Incentive	Neutral	Minor Disincentive	Major Disincentive	Other Comments if any
d. With effect from the year of assessment 1975/76, the income of any co-operative society from such business as specified by the Minister will be liable to income tax						
e. Changes to the exemption from tax of profits from the sale of gems through the Gem Corporation:						
i. Any company incorporated on or after 6th November 1974, will not be entitled to exemption from income tax						
ii. Dividends declared after 1st April 1974, on shares other than ordinary shares will not be exempt from dividend tax						
iii. Dividends declared after 1st April 1974, on ordinary shares will be exempt from dividend tax only up to a maximum of 10% of paid-up value of shares						
iv. Dividends declared out of earnings after 1st April 1975, will be liable to dividend tax						
f. Every person carrying on a trade, business, profession or vocation is required to close accounts on the 31st March each year						
g. The definition of an "Approved Investment" for purposes of investment relief under section 16CC of the Act, has been extended to include (among others) any sum invested on or after 1st April 1975, in the purchase of new ordinary shares in a company approved by the Minister and engaged solely in the construction and sale of houses						
h. A Company falling within the definition of a "People's Company", will be liable to income tax at a reduced rate of 40% of taxable income, with effect from the year of assessment 1976/77						
i. Subject to a specified upper limit, a company investing in any undertaking on or after 1st April 1976, in accordance with investment plans approved by the Authorities, will be entitled to a deduction from income tax payable for that year of assessment of an amount equal to the investment or 10% of taxable income for that year, whichever is lower						
j. Subject to a specified ceiling, where a person carrying on an undertaking in Sri Lanka has in the year preceding any year of assessment, commencing on or after 1st April 1976, brought foreign exchange to Sri Lanka for the purpose of that undertaking, he will be entitled to a deduction from the income tax payable by him for that year of assessment, of an amount equal to the amount of foreign exchange brought in or 20% of the income tax attributable to the income from such undertaking for that year of assessment, whichever is lower						
k. Where any person carrying on an undertaking in agriculture, fishing, mining or manufacture or in the promotion of any of these, has after 1st January 1976, increased the number of persons other than executives employed in that undertaking, such person can claim a deduction (of an amount specified in the Law) from income tax attributable to that undertaking						

Question 11 continued:

	Major Incentive	Minor Incentive	Neutral	Minor Disincentive	Major Disincentive	Other Comments if any
l. Changes to the upper slabs and rates of income tax payable by resident individuals:						
a. Increase in rates for the year of assessment 1975/76, with the maximum rate raised from 65% to 75%						
b. Reduction in rates from the year of assessment 1976/77, with the maximum rate lowered from 75% to 50%						
m. Introduction of an Expenditure Tax						

12. Would you be willing, if necessary, to complete another questionnaire or to grant us an interview? Yes ☐ No ☐

If Yes, at what address may we write to you?

.....

.....

THANK YOU FOR COMPLETING THIS QUESTIONNAIRE

Some Comparative Tax Variables - In 1975

	Sri Lanka[208]	Malaysia[153][154]	The Philippines[153][154]
1. Main Business Taxes - Direct	Income Tax	Income Tax, Supplementary Development Tax and Excess Profit Tax	Income Tax
- Indirect	Business Turnover Tax, Customs and Excise	Sales Tax, Customs and Excise	Sales Tax and Customs Duties
2. Rates of Income Tax			
Companies - Income	60% for resident cos. 35% for small cos. 66% " non-res. cos.	40% Income Tax 5% Development Tax 5% Excess Profit Tax on income over $200,000	25% up to income of ₱100,000 35% thereafter
- Withholding	$33\frac{1}{3}$% on dividends	None	35% on Dividends
Individuals	$7\frac{1}{2}$ to 65%	6 to 55%	3 to 70%
3. Incentives			
Tax holidays	For 'Approved Industries': exemption for 5 years	For 'Pioneer Industries':2-8yrs. (With capital allowances deferred to the post-pioneer period.)	For 'Pioneer Enterprises':full exemption for 5 years, and thereafter, reducing exemptions until end of 15 years.
Accelerated Depreciation	Accelerated depreciation at time of acquisition $33\frac{1}{3}$-80%	As alternative to Pioneer status or Investment Tax Credit, 90% of cost may be written-off in 5 yrs. by qualifying business	Accelerated Depreciation up to twice the normal rate for 'Preferred Non-pioneer Enterprises'
Other benefits on Acquisition of Fixed Assets	Development Rebate of 20-40% of cost of fixed assets on commencement of business and at any time for agriculture	Investment Tax Credit of 25% of cost of fixed assets as alternative to Pioneer Status	-
Investment Relief	For investment by individuals or companies in 'Approved Projects'	-	For Investment in 'Pioneer Enterprises'
Other Incentives	Special Incentives for exports and tourism	Labour utilisation relief; Special locational incentives; Special incentives for export and tourism	Special incentives for exports and tourism

Crosstabulation - Age of Firm v Country of operation

	Number of firms in Country sample		
Age of Firm	SL	Malaysia	Philippines
Less than 5 years	4	2	3
5 - 10 years	14	2	0
10 - 30 years	23	10	2
More than 30 years	32	4	2
	73	18	7

Testing the null hypothesis that the age structure of SL firms does not differ from that of Malaysian and Philippine firms;

Contingency Table

	Country		
Age of firm	SL	Malaysia and the Philippines	Total
30 years and under	41	19	60
More than 30 years	32	6	38
	73	25	98

$\chi^2 = 3.09$ with 1 d.f.

$\therefore$ the null hypothesis is rejected at a 0.1 level of confidence.

Appendix 11.2

Crosstabulation - Form of organisation v Country of operation

Form of Organisation	Number of firms in Country sample		
	SL	Malaysia	The Philippines
A. Public Limited liability company	31	4	-
B. Private Limited liability company	35	12	1
C. Corporation	-	-	6
D. Partnership	4	1	-
E. Individual proprietorship	1	-	-
F. Mixed	3	-	-

Appendix 11.3

Crosstabulation - Management v Country of operation

Management	Number of firms in Country sample		
	SL	Malaysia	The Philippines
Owner	52	7	5
Professional	22	11	2
	74	18	7

Testing the null hypothesis that the management structure of SL firms is similar to that of Malaysian firms:

$\chi^2 = 6.2$ with 1 d.f.

$\therefore$ the null hypothesis is rejected at a 0.025 level of significance.

Crosstabulation - Organisation Objectives v Country of operation

Organisation Objectives (Six most common items)	Number of firms in Country sample		
	SL	Malaysia	The Philippines
Maximisation of Profits	51	14	7
Maximisation of owners' wealth	16	7	-
Maximisation of Market share	24	13	3
Maximisation of Value added	9	2	2
Maximisation of Employee welfare	26	9	2
Maintenance of a Going concern	53	7	3
Total of firms in Country sample	74	18	7
The Most Important Objective			
A. Maximisation of profits	25	12	6
B. Maximisation of owners' wealth	3	2	-
C. Maximisation of market share	6	3	-
D. Maximisation of Value added	2	-	-
E. Maximisation of Employee welfare	1	-	-
F. Maintenance of a Going concern	30	1	-
G. Growth	1	-	-
H. Consumer satisfaction	1	-	-
I. Maximising employment	1	-	-
J. Social Responsibility	-	-	1
K. Providing for dependents	1	-	-

Testing the null hypothesis that whether a firm chooses a task-related maximising objective or a maintenance objective is not related to the country of operation:

Contingency Table

Objectives	Country		
	SL	Malaysia & Philippines	Total
Task related maximising objective [A+B+C+D+G]	37	23	60
Maintenance of a going concern	30	1	31
	67	24	91

$\chi^2 = 10.12$ with 1 d.f.

$\therefore$ The null hypothesis is rejected at a 0.005 level of significance.

Appendix 11.5

Crosstabulation - Environmental Constraints v Country of operation

Constraints on business	No. of firms in Country sample		
	SL	Malaysia & The Philippines	Total
A. Import Controls			
Yes	57	10	67
No	17	15	32
	74	25	99

Testing the null hypothesis that the perceptions of import controls as a constraint are the same in the two country groups:

$$\chi^2 = 11.7 \text{ with } 1 \text{ d.f.}$$

∴ the null hypothesis is rejected at a 0.005 level

B. Market Limitations			
Yes	20	15	35
No	54	10	64
	74	25	99

Testing the null hypothesis that the perceptions of market limitations as a constraint are the same in the two country groups:

$$\chi^2 = 8.89 \text{ with } 1 \text{ d.f.}$$

∴ the null hypothesis is rejected at a 0.005 level

C. Shortage of technical and professional skills			
Yes	14	11	25
No	60	14	74
	74	25	99

Testing the null hypothesis that the perceptions of shortage of technical and professional skills as a constraint are the same in the two country groups:

$$\chi^2 = 6.23 \text{ with } 1 \text{ d.f.}$$

∴ the null hypothesis is rejected at a 0.025 level

Appendix 11.6

Crosstabulation - Perception of Tax Burden v Management (Malaysia & The Philippines)

	Management		
	Owner	Professional	Total
Taxation as a constraint on achievement of objectives			
Yes	8	6	14
No	4	7	11
	12	13	25

Testing the null hypothesis that taxes are perceived as a constraint equally by owner-managers and professional managers.

$$\chi^2 = 1.07 \text{ with } 1 \text{ d.f.}$$

∴ the null hypothesis cannot be rejected at a 0.25 level of significance.

Appendix 11.7

Crosstabulation - Perception on Incentives v Country of operation

(a)

Incentive	Number of firms who feel that incentive has been useful		
	SL	Malaysia	Philippines
Tax Holiday	41	13	4
Accelerated Depreciation	63	13	4
Total in group	74	18	7

(b)

Incentive	Number of firms who believe incentive to be one of two most useful incentives		
	SL	Malaysia	Philippines
Tax Holiday	22	12	4
Accelerated Depreciation	39	8	1

Using the response in part (b) of this schedule as a measure of appreciation of each incentive, and,

testing the null hypothesis that the relative appreciation of the two incentives in SL does not differ from that in the other two countries combined,

$$\chi^2 = 5.61 \text{ with } 1 \text{ d.f.}$$

$\therefore$ The null hypothesis is rejected at a 0.025 level of significance.

Appendix 11.8

Crosstabulation - Growth of firms v Country of operation

Growth Class No.	Level	Number of firms in Country sample: SL	Malaysia	The Philippines
1	Nil	11	2	-
2	Less than 10%	8	-	-
3	10-50%	28	6	3
4	50-100%	13	6	1
5	More than 100%	14	4	2
Growth Index, GI^* =		3.2	3.6	3.8

Testing the null hypothesis that the proportion of low and nil growth firms in SL is no different from that in the other two countries combined.

Contingency Table	Number of firms in: SL	Malaysia & The Philippines	Total
Growth Class			
Low (1+2)	19	2	21
High (3+4+5)	55	22	77
	74	24	98

$\chi^2 = 3.24$ with 1 d.f.

$\therefore$ the null hypothesis is rejected at a 0.1 level of confidence.

$$GI^* = \frac{\sum_{n=1}^{5} (n \times \text{Number of firms in } n\text{th growth class})}{\text{Total number of firms in Country sample}}$$

Appendix 11.9

Growth Index* with reference to type of management

Country	Management: Owner	Management: Professional
Sri Lanka	3.5	2.3
Malaysia	3.0	3.7

$$* \text{ Growth Index} = \frac{\sum_{n=1}^{5} (n \times \text{Number of firms in } n^{th} \text{ Growth Class})}{\text{Total number of firms in Management/Country sample}}$$

where growth class is defined as in Appendix 11.8.

Appendix 11.10

Crosstabulation - Business Gearing v Country of operation

Contribution to Capital of sources other than owners' capital Gearing Class	Number of firms in Country sample SL	Malaysia	The Philippines
1. Negligible or nil	10	1	-
2. Much less than owners' capital	18	4	1
3. Somewhat less than owner's capital	8	2	1
4. About the same as owners' capital	13	3	1
5. Greater than owners' capital	21	7	3
Gearing Index, I^*	3.3	3.7	4.1

$$* \; I = \frac{\sum_{n=1}^{5} (n \times \text{Number of firms in } n^{th} \text{ gearing class})}{\text{Total number of firms in country sample}}$$

Appendix 11.11

Crosstabulation - Gearing v Relevance of Tax considerations v

Country of operation

Firms for whom tax considerations are relevant in Borrowing decisions/number in gearing class	Number of firms in Country Sample		
	SL	Malaysia	The Philippines
Gearing class 1 (low gearing)	1/10	0/1	N.A.*
2	4/18	2/4	0/1
3	2/8	1/2	0/1
4	3/13	0/3	0/1
5 (high gearing)	6/21	2/7	3/4

* N.A. = not applicable as there were no firms in gearing class.

Appendix 11.12

Crosstabulation - Relevance of tax in Profit Distributions v Country operation

Taxation as a consideration on Profit Distributions	Number of firms in Country Sample	
	Malaysia	SL and The Philippines
Yes	8	48
No	10	33
	18	81

Testing the null hypothesis that the relevance of tax considerations in country samples is the same in both country samples.

$$\chi^2 = 1.32 \text{ with } 1 \text{ d.f.}$$

∴ The null hypothesis is rejected at a 0.25 level of significance.

Appendix 11.13

Response of Professional Observers

	Malaysia	Philippines	Total
(a) Total Number of Responses	9	9	
(b) The following are believed to be constraints on business activity			
Items listed in questionnaire			
Shortage of professional & technical skills	7	6	13
Shortage of finance	5	8	13
Market Limitations	7	4	11
Taxation	6	4	10
Import Controls	5	5	10
Price Controls	3	5	8
Labour relations	1	3	4
Items added by respondents			
Excessive Government control	2		
Political Developments	1		
Attitude of government		2	
Land-ownership problems		1	
(Lack of) peace and order		1	
Dumping		1	
(c) Among the most effective incentives were included			
Tax Holidays	5	2	
Accelerated Depreciation allowances	1	0	
(d) Index* of relevance of taxation considerations in decisions relating to			
Financing	3.4	2.7	
Distribution of Profits	4.0	3.6	

$$\text{Index}^* = \left.\begin{array}{l} [(\text{No. of observers believing tax considerations to be relevant to all firms})\times 5] \\ +[(\text{" " " " " " " " to most "})\times 4] \\ +[(\text{" " " " " " " " to some "})\times 3] \\ +[(\text{" " " " " " " " to a few "})\times 2] \\ +[(\text{" " " " " " " " to no firm})\times 1] \end{array}\right\} \div \text{Total number of responses}$$

Appendix 12

UNIVERSITY OF WARWICK

SCHOOL OF INDUSTRIAL AND BUSINESS STUDIES

Questionnaire to Foreign Investors in Developing Countries

The confidentiality of your answers to this questionnaire will be respected. No one outside the research team at the University of Warwick, School of Industrial and Business Studies will see the completed questionnaire. If however, you do not wish to divulge the name of your firm, you may prefer to leave question 1 unanswered.

Most questions can be answered with a tick (✓) in the appropriate box. If you wish to make any additional comments, please use the space below each question or that at the end of the questionnaire.

We should be most grateful if you would please return the completed questionnaire as soon as possible.

Thank you very much for helping in our research project.

1. Name of Firm .....
   (If your firm is one of a group of companies, please answer on the basis of the group, if you think this is more sensible)

2. Country of residence or registration of business.....

3. Do you have investments in what are generally known as Developing Countries? Yes ☐ No ☐

4. In your experience have you found taxation in the host country to be a significant consideration in deciding to invest in developing countries?

Always	Often	Sometimes	Seldom	Never

5. Here is a list of difficulties that foreign investors sometimes face in developing countries. Have you found these to be relevant?

	In a Number of Countries	In Two or Three Countries	Rarely or Never
a. Political uncertainty			
b. Administrative red-tape in obtaining approval			
c. Scarcity of technical and managerial skills			
d. Threat of nationalisation			
e. Inadequacy of financial and commercial services			
f. Currency exchange controls			
g. Import controls			
h. Difficult labour relations			
i. Others (specify)			
j.			
k.			

6. Which one or two problems out of the list in question 5 would you say have caused you the most difficulty?

a	b.	c.	d.	e.	f.	g.	h.	i.	j.	k.

7. Where would you place difficulties caused by taxation in developing countries in relation to those in question 5?

Compared with	Taxation is a		
	More Important Problem	Equally Important Problem	Less Important Problem
a. Political uncertainty			
b. Administrative red-tape			
c. Scarcity of technical and managerial skills			
d. Threat of nationalisation			
e. Inadequacy of financial and commercial skills			
f. Currency exchange controls			
g. Import controls			
h. Difficult labour relations			
Others, if specified in question 5			
i.			
j.			

8. Do you have investments in any of the following countries?

a. Jamaica ☐
b. Malaysia ☐
c. Nigeria ☐
d. The Philippines ☐
e. Sri Lanka ☐
f. Zambia ☐

9. If you answered Yes to question 8....., would your establishment in..... or someone at head office, be willing to complete a questionnaire relating to that country?

10. If Yes to question 9, could you please give us their address

.....

.....

11. If you have no investments in ....., is this because,

a. You have not considered the possibility ☐
b. You have considered the possibility, but have decided against investment ☐
c. The possibility is now under consideration ☐
d. You had investments in the past, but no longer have any interests in that country ☐
e. Other (specify) ..... ☐

12. a. Would you be willing, if necessary, to clarify your answers to this questionnaire either by completing another questionnaire or by granting us an interview? Yes ☐ No ☐

b. If Yes, at what address may we write to you?

.....

.....

THANK YOU FOR COMPLETING THIS QUESTIONNAIRE

Appendix 13

UK taxation of foreign Income of companies

The UK tax law relating to foreign earnings of companies is complex and includes a multitude of provisions to enable both assessment to tax and the granting of relief as well as to check tax-avoidance. This appendix summarises the main provisions of the law generally applicable to companies resident in the UK.

1. A company resident in the UK is chargeable to Corporation tax on its trading profits wherever arising, whether or not such income is remitted to the UK. Similarly any losses incurred on trading in any part of the world may be set off against profits arising in any other part.

2. If, however, foreign operations are carried on through subsidiary companies set-up outside the UK, only dividends (and interest and similar payments) paid to the UK holding company are chargeable to tax in the UK. Once again, whether or not these dividends are remitted back to the UK is irrelevant. As only distributed profits of an overseas subsidiary are taxable in the UK any losses incurred by such a subsidiary cannot be set-off against other income in computing UK taxes.

3. Double taxation relief is granted in the UK, both unilaterally and under treaties with foreign countries.

4. Under provisions for unilateral relief, taxation paid in a foreign country on profits or dividends is allowed as a deduction against UK taxes payable on that income.

   Dividends received are therefore grossed-up in calculating UK corporation tax; the exact procedure however depends on the interest of the UK company in the foreign company. If the UK company has more than 10% of the voting power in the foreign company then to dividends are added all

foreign taxes paid on the dividends (i.e. withholding tax and other underlying taxes). Double tax relief is then allowed in respect of all underlying foreign tax. If, however, the voting power of the UK recipient of dividends in the foreign company is less than 10%, only taxes paid specifically on the dividend may be added to the dividend and claimed for double tax relief. The relief allowed in each case is however limited to the foreign tax added to obtain gross dividend or the UK corporation tax on the gross dividend, whichever is the lower. Double taxation relief cannot be carried over from one period to another: any foreign tax that cannot be relieved in the relevant period is not eligible for set-off against UK taxes of any other year.

5. The UK has entered into double tax relief agreements with a large number of foreign countries (over 75 agreements were in operation at the begin ning of 1980). These treaties may provide for additional relief over and above that given unilaterally or specify taxes to be included in the definition of underlying tax. Generally, they also provide for the free exchange of information between the tax authorities of the two countries.

6. UK law provides for tax-sparing relief in the UK on foreign income where this is agreed in the relevant double taxation relief treaty. The effect of tax-sparing relief is that foreign tax forgone in a foreign country under an incentive scheme to provide industrial (or similar) development, is to be treated as if it were tax paid in that territory, for purposes of granting double taxation relief.

7. A limitation on the recovery of double taxation relief can arise when the UK recipient of foreign dividends in turn pays out its foreign earnings as dividends in the UK. When the dividend is paid by the UK

company it has to also pay Advance Corporation tax at a rate determined by the basic rate of personal tax and this tax is recoverable from corporation tax before the computation of double taxation relief. Under such circumstances it is very likely that some double taxation will go unrelieved. (A UK company may, however, surrender its Advance Corporation Tax relief to a 51% owned UK subsidiary, thus increasing its ability to receive double taxation relief.)

Sources: (1) Prest[149]

(2) Simons Taxes[163]

(3) Pritchard[150]

Appendix 14

LDC-Related Investment Appraisal Procedures of MNCs

Appendix 14.1

Main Techniques of Investment Appraisal used to evaluate LDC investment

	No. of firms
Internal Rate of Return (IRR)	2
IRR + Net Present Value (NPV)	1
IRR + NPV + Payback	2
Payback	1
Maintainable Return on Capital Invested	1
	7

Appendix 14.2

In the evaluation of developing country investment projects, the company looks at

	No. of firms
(a) tax flows to the project in isolation	1
(b) the project's impact on Group tax flows	2
(c) both (a) and (b)	4
	7

Appendix 14.3

Tax related inputs to investment evaluations

	No. of firms
Host Country taxes (Income and Distribution or remittance based) only	1
Host Country taxes and home country income taxes	6
	7

Appendix 14.4

Possible future changes in tax structure allowed for in evaluation of investments

	No. of firms	Method used
Yes	1	Best estimates
Yes if a specific change is virtually certain	1	Sensitivity analysis
No	5	
	7	

Appendix 14.5

Location of LDC Investment Evaluations

Evaluations are carried out	For Initial Investment	For expansion and Replacement investment
at Head Office	4	-
at Head Office and local office	3	6
at Head Office and local office with help of outside consultants	-	1
	7	7

Appendix 15.1

Summary of factors Promoting or Constraining Corporate achievement

Source	Internal	External	Total
Factors			
Promoting	87	37	124
Constraining	6	237	243
	93	274	367

Testing the null hypothesis that in reports of factors affecting corporate achievement, the proportion of promotional to constraining causes is the same for factors of an internal nature as for those originating from an external source:

$$\chi^2 = 20.1 \text{ with } 1 \text{ d.f.}$$

∴ The null hypothesis is rejected at a 0.001 level of significance.

Appendix 15.2

Analysis of Factors Promoting Corporate Achievement

	Area			
	UK	Other Developed Countries	LDCs	Total
Source				
Internal	37[82%]	37[71%]	13[48%]	87
External	8[18%]	15[29%]	14[52%]	37
	45[100%]	52[100%]	27[100%]	124

Testing the null hypothesis that the proportion of internal to external variables among factors promoting corporate achievement is the same for all geographical areas:

$$\chi^2 = 9.3 \text{ with } 2 \text{ d.f.}$$

∴ The null hypothesis is rejected at a 0.01 level of significance.

Appendix 15.3

Analysis of All Factors Influencing Corporate Achievement

	Area			
	UK	Other Developed Countries	LDCs	Total
Source				
Internal	37[37%]	43[28%]	13[12%]	93
External	64[63%]	112[72%]	98[88%]	274
	101[100%]	155[100%]	111[100%]	367

Testing the null hypothesis that the proportions of internal and external factors affecting corporate performances are the same in all geographical areas:

$$\chi^2 = 18.1 \text{ with } 2 \text{ d.f.}$$

$\therefore$ The null hypothesis is rejected at a 0.005 level of significance.

External Factors constraining Corporate Achievement

	UK	Other Developed Countries	LDCs	Total
(a) Market and Resource related				
Market demand/supply/prices	16	33	13	62
Industrial relations	14	4	8	26
Shortage of supplies and services	1	4	11	16
Difficult trading conditions	1	4	-	5
	32[57%]	45[46%]	32[38%]	109
(b) General Country and Economy related				
State of the economy	-	21	9	30
Fluctuations in currency ex. rates	7	10	3	20
Weather/climate	5	3	3	11
Political uncertainty/unrest	-	2	8	10
Balance of payments problems	-	-	3	3
Inflation	1	1	-	2
Credit problems	-	-	1	1
	13[23%]	37[38%]	27[32%]	77
(c) Government controlled				
Requirements for local participation	-	-	11	11
Price controls	4	3	3	10
Government intervention	4	5	-	9
Taxation	1	2	4	7
Devaluation	-	2	2	4
Import controls	-	1	2	3
Quality standards	-	2	-	2
Exchange restrictions	-	-	2	2
Dividend control	1	-	-	1
Common agricultural policy	1	-	-	1
Compulsory requisition	-	-	1	1
	11[20%]	15[16%]	25[30%]	51
Total	56[100%]	97[100%]	84[100%]	237

Testing the null hypothesis that the possibility of occurrence of the above mentioned categories of constraint is the same in the three geographical areas studied,

$$\chi^2 = 9.5 \text{ with } 4 \text{ d.f.}$$

$\therefore$ The null hypothesis is rejected at a 0.05 level of confidence.

Appendix 16.1

Analysis of Budget Proposals - 1965 - 1977

Type of Tax Measure	Number of proposals leading to: A Reduction in Taxes (+)	An Increase in Taxes (-)
Income Tax - Individuals		
Rates - lower slabs	1	1
- upper slabs	3	2
Personal and Family Relief	5	-
Determination of assessable income	5	2
Capital Gains Tax	5	1
Compulsory Savings and Ceiling on Income	4	2
	23	8
Income Tax - Corporate		
Rates	3	1
Bases	-	3
Compulsory savings	1	2
	4	6
Capital Taxes		
Wealth Tax	2	4
Gift Tax	1	-
Estate Duty	2	1
Capital Levy	-	1
	5	6
Other Taxes		
Business Turnover Tax	6	9
Customs Duty	2	4
Excise	-	3
Foreign Exchange Tax	1	-
Visa Tax	1	1
Bank Debits Tax	1	1
Foreign Exchange Entitlement Certificates	1	3
Rice Subsidy Tax	1	-
Licence Fees	-	2
Stamp Duty	1	1
Expenditure Tax	1	1
	15	25
Incentives		
Incentives for investment/production/ exports etc.	18	11
Incentives for savings and remittances	4	1
Accelerated Capital Allowances	1	3
Amnesties	3	-
	26	15

Appendix 16.2

Budget Proposals and Business Reaction under different Governments

A. Budget Proposals

Government	Number of proposals leading to Decrease in Tax Burden	Increase in Tax Burden	Total
* UNP	32	15	47
** UF/SLFP	23	30	53
	55	45	100

Testing the null hypothesis that the proportion of favourable to adverse proposals is no different under the two governments:

$$\chi^2 = 6.13 \text{ with } 1 \text{ d.f.}$$

∴ The null hypothesis is rejected at a 0.025 level of confidence.

B. Business Reactions to Budget

Government	Number of Taxpayer Comments Favourable	Adverse	Total
* UNP	60	18	78
** UF/SLFP	30	5	35
	90	23	113

Testing the null hypothesis that the proportion of favourable to adverse comments is no different under the two governments:

$$\chi^2 = 1.12 \text{ with } 1 \text{ d.f.}$$

∴ The null hypothesis is rejected at a 0.25 level of confidence.

---

* UNP ≡1965, 1968 and 1977 budget speeches.

** SLFP ≡1970, 1974 and 1975 budget speeches.

DEFINITIONS OF RATIOS

	Abbreviation	Variable measured	Method of computation	Conventions used in computation
1.	TX	Tax burden	$\frac{\text{Tax charge in the Profit and Loss Account}}{\text{Profit before tax for the year}} \times 100$	(a) The tax charge includes provisions for both current and deferred tax. (b) Profit before tax includes profit from all sources credited to the Profit and Loss Account after charging depreciation and interest. (c) If Profit before tax is negative, and (a) if a tax charge is made in the Profit & Loss A/C, TX ≡ 10 (b) if no " " " " " " " " " , TX 0 (d) Upper limit to TX ≡ 100
2.	PBT	Pre-tax profitability	$\frac{\text{Profit before tax for the year}}{\text{Ownership interest at end of year}} \times 100$	(a) Profit before tax defined as for TX (b) Ownership interest comprises all share capital, minority interest and reserves.
3.	RTO	Returns to equity	$\frac{\text{Profit available to ordinary shareholders}}{\text{Ordinary shareholders' interest at end of year}} \times 100$	(a) Profit available to ordinary shareholders comprises net profit for the year after deducting tax, minority interest and preference dividends. (b) Ordinary shareholders' interest comprises ordinary share capital and all reserves.
4.	AFA	Additions to fixed assets	$\frac{\text{Additions to fixed assets during the year}}{\text{Fixed assets at beginning of year}} \times 100$	(a) Additions to fixed assets during the year ≡ Net book value of fixed assets at end of year - Net book value of fixed assets at beginning of year + depreciation for the year. (b) Fixed assets at beginning of year ≡ Net book value of fixed assets at beginning of year. (c) In a number of cases some transactions relating to fixed assets (mainly concerning asset revaluations and consolidation of subsidiaries not previously consolidated) were not recorded. This ratio has been treated as a missing value in such cases.
5.	ITA	Increase in total assets	$\frac{\text{Increase in total assets during the year}}{\text{Total assets at beginning of year}} \times 100$	(a) Increase in total assets ≡ Book value of total assets at end of year - Book value of total assets at beginning of year. (b) Total assets at beginning of year ≡ Book value of total assets at beginning of year. (c) Increase in total assets has been treated as a missing value wherever additions to fixed assets were unavailable.
6.	LS	Level of financial gearing	$\frac{\text{Non-tax liability at end of year}}{\text{Total assets at end of year}} \times 100$	Non-tax liabilities comprise all long-term and current liabilities excluding tax liability and dividends payable.
7.	TP	Level of tax liability	$\frac{\text{Taxes payable at end of year}}{\text{Total assets at end of year}} \times 100$	Taxes payable include amounts outstanding under both current and non-current liabilities.
8.	DRS	Level of total debtors	$\frac{\text{Total debtors at end of year}}{\text{Total assets at end of year}} \times 100$	
9.	CI	Level of Liquid funds	$\frac{\text{Liquid assets at end of year}}{\text{Total assets at end of year}} \times 100$	Liquid assets ≡ Cash and bank balances and short-term investments.
10.	DOE	Dividend payout	$\frac{\text{Ordinary dividend paid and proposed for the year}}{\text{Profit for the year available to ordinary shareholders}} \times 100$	(a) Where profit available to ordinary shareholders is a negative value (a) if an ord. div. is paid in the year, DOE ≡ 200 (b) if no " " " " " " " " ≡ 0 (b) Where dividends to ordinary shareholders exceed profit available to ord. shares, upper limit to DOE ≡ 200.

MEANS AND [STANDARD DEVIATIONS] OF RATIOS

RATIOS	Year	1	2	3	4	5	6	7	8	9	10	11
1. TX		49.3	54.2	47.9	48.7	51.9	52.4	51.8	48.7	56.1	64.0	66.7
		[23.8]	[22.7]	[18.8]	[20.5]	[20.3]	[17.8]	[29.4]	[25.1]	[23.7]	[17.5]	[18.3]
2. PBT		20.4	23.9	24.8	25.5	23.7	29.6	26.0	21.0	19.3	22.5	18.2
		[18.1]	[15.5]	[14.0]	[14.1]	[15.6]	[15.4]	[14.2]	[14.7]	[14.1]	[13.9]	[12.9]
3. RTO		6.9	10.1	12.4	12.7	11.6	14.0	10.7	8.7	7.7	8.7	6.7
		[7.7]	[8.3]	[6.3]	[7.4]	[9.8]	[7.5]	[5.4]	[8.1]	[5.8]	[5.6]	[6.3]
4. AFA		12.6	8.3	8.8	14.9	12.1	20.4	12.0	12.1	15.3	8.6	7.9
		[19.4]	[9.6]	[25.6]	[18.6]	[14.8]	[25.9]	[14.3]	[9.9]	[19.8]	[9.5]	[9.2]
5. ITA		7.7	5.8	7.7	9.5	7.5	23.7	8.6	0.2	4.4	3.8	-1.1
		[13.0]	[9.0]	[9.7]	[8.3]	[9.4]	[21.8]	[10.8]	[10.7]	[6.5]	[8.7]	[11.1]
6. LS		27.3	28.7	29.2	30.2	31.3	35.3	37.2	35.0	34.9	36.8	35.2
		[17.9]	[17.0]	[18.1]	[18.3]	[19.6]	[21.2]	[21.6]	[20.9]	[20.2]	[16.5]	[17.5]
7. TP		16.1	15.6	16.2	17.0	17.0	17.4	17.4	16.3	15.9	15.9	12.9
		[12.9]	[11.1]	[10.1]	[10.1]	[10.5]	[11.3]	[11.0]	[8.9]	[10.3]	[10.7]	[8.4]
8. DRS		16.5	18.4	19.6	20.0	18.7	21.0	19.6	19.6	18.9	19.8	18.6
		[10.4]	[10.8]	[11.0]	[10.0]	[9.5]	[9.8]	[9.1]	[9.2]	[8.8]	[9.3]	[11.0]
9. CI		11.6	10.4	9.3	11.1	11.5	11.4	9.5	8.9	7.5	8.7	7.8
		[18.1]	[15.7]	[10.2]	[12.5]	[11.6]	[11.2]	[9.2]	[9.2]	[7.4]	[12.9]	[10.2]
10. DOE		58.6	79.3	68.4	76.6	81.3	67.2	65.2	69.3	86.6	88.9	85.9
		[31.6]	[35.3]	[25.3]	[32.2]	[45.0]	[32.6]	[40.6]	[42.2]	[58.8]	[53.6]	[63.0]

Appendix 17.3

YEAR 1

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.6784 N(19) SIG .001	TX WITH RTO	0.1651 N(19) SIG .250								
AFA WITH TX	0.0049 N(17) SIG .493	AFA WITH PBT	0.3458 N(17) SIG .087	AFA WITH RTO	0.3182 N(18) SIG .099	ITA WITH TX	0.1682 N(18) SIG .252	ITA WITH PBT	0.5315 N(18) SIG .012	ITA WITH RTO	0.1571 N(19) SIG .260
LS WITH PBT	-0.3404 N(19) SIG .077	LS WITH RTO	-0.4641 N(20) SIG .020	LS WITH AFA	-0.2612 N(18) SIG .148	LS WITH ITA	0.3070 N(19) SIG .101	LS WITH DRS	0.3699 N(20) SIG .054		
LS WITH TP	-0.6737 N(20) SIG .001	LS WITH TX	-0.0649 N(19) SIG .396	LS WITH CI	-0.4812 N(20) SIG .016	TP WITH TX	0.5318 N(19) SIG .010	TP WITH CI	0.7459 N(20) SIG .001	TX WITH CI	0.2791 N(19) SIG .124
DDE WITH RTO	0.1797 N(20) SIG .224										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	0.5604 N(14) SIG .019	TX WITH RTO	-0.0945 N(14) SIG .374								
AFA WITH TX	-0.0385 N(12) SIG .453	AFA WITH PBT	0.4378 N(12) SIG .077	AFA WITH RTO	0.3503 N(12) SIG .132	ITA WITH TX	0.0440 N(13) SIG .443	ITA WITH PBT	0.5714 N(13) SIG .021	ITA WITH RTO	0.3956 N(13) SIG .090
LS WITH PBT	-0.6176 N(14) SIG .009	LS WITH RTO	-0.6615 N(14) SIG .005	LS WITH AFA	-0.2137 N(12) SIG .252	LS WITH ITA	0.0549 N(13) SIG .429	LS WITH DRS	0.2879 N(14) SIG .159		
LS WITH TP	-0.8242 N(14) SIG .001	LS WITH TX	-0.2264 N(14) SIG .218	LS WITH CI	-0.6220 N(14) SIG .009	TP WITH TX	0.4945 N(14) SIG .036	TP WITH CI	0.7934 N(14) SIG .001	TX WITH CI	0.3714 N(14) SIG .096
DDE WITH RTO	-0.0902 N(14) SIG .380										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.7464 N(15) SIG .001	TX WITH RTO	-0.0054 N(15) SIG .492								
AFA WITH TX	-0.2308 N(14) SIG .214	AFA WITH PBT	0.1736 N(14) SIG .276	AFA WITH RTO	0.1215 N(15) SIG .333	ITA WITH TX	0.5214 N(15) SIG .023	ITA WITH PBT	0.7464 N(15) SIG .001	ITA WITH RTO	0.2561 N(16) SIG .169
LS WITH PBT	-0.1357 N(15) SIG .315	LS WITH RTO	-0.3385 N(16) SIG .100	LS WITH AFA	-0.1036 N(15) SIG .357	LS WITH ITA	0.3324 N(16) SIG .104	LS WITH DRS	0.5471 N(16) SIG .014		
LS WITH TP	-0.5882 N(16) SIG .008	LS WITH TX	0.0500 N(15) SIG .430	LS WITH CI	-0.4382 N(16) SIG .045	TP WITH TX	0.4714 N(15) SIG .038	TP WITH CI	0.8176 N(16) SIG .001	TX WITH CI	0.3893 N(15) SIG .076
DDE WITH RTO	0.0265 N(16) SIG .461										

YEAR 2

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.2878 N(19) SIG .116	TX WITH RTO	-0.1719 N(19) SIG .241								
AFA WITH TX	-0.3166 N(17) SIG .108	AFA WITH PBT	0.0736 N(17) SIG .389	AFA WITH RTO	0.3295 N(18) SIG .091	ITA WITH TX	-0.5377 N(18) SIG .011	ITA WITH PBT	0.3063 N(18) SIG .113	ITA WITH RTO	0.6351 N(19) SIG .002
LS WITH PBT	0.0369 N(19) SIG .440	LS WITH RTO	0.0782 N(20) SIG .372	LS WITH AFA	0.3419 N(18) SIG .082	LS WITH ITA	0.0912 N(19) SIG .355	LS WITH DRS	0.6170 N(20) SIG .002		
LS WITH TP	-0.6062 N(20) SIG .002	LS WITH TX	-0.1088 N(19) SIG .329	LS WITH CI	-0.1513 N(20) SIG .262	TP WITH TX	0.5143 N(19) SIG .012	TP WITH CI	0.3453 N(20) SIG .068	TX WITH CI	0.0351 N(19) SIG .443
DOE WITH RTO	-0.5835 N(20) SIG .003										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	-0.0374 N(14) SIG .450	TX WITH RTO	-0.3758 N(14) SIG .093								
AFA WITH TX	-0.7840 N(13) SIG .001	AFA WITH PBT	-0.0523 N(13) SIG .433	AFA WITH RTO	0.2889 N(13) SIG .169	ITA WITH TX	-0.5912 N(14) SIG .013	ITA WITH PBT	0.4158 N(14) SIG .068	ITA WITH RTO	0.6176 N(14) SIG .009
LS WITH PBT	-0.0945 N(14) SIG .374	LS WITH RTO	0.0901 N(14) SIG .380	LS WITH AFA	0.4814 N(13) SIG .048	LS WITH ITA	0.2527 N(14) SIG .192	LS WITH DRS	0.6189 N(14) SIG .009		
LS WITH TP	-0.7481 N(14) SIG .001	LS WITH TX	-0.2791 N(14) SIG .167	LS WITH CI	-0.2489 N(14) SIG .195	TP WITH TX	0.3564 N(14) SIG .105	TP WITH CI	0.4840 N(14) SIG .040	TX WITH CI	0.0154 N(14) SIG .479
DOE WITH RTO	-0.9033 N(14) SIG .001										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.4039 N(15) SIG .068	TX WITH RTO	0.1250 N(15) SIG .329								
AFA WITH TX	-0.3691 N(13) SIG .107	AFA WITH PBT	-0.1928 N(13) SIG .264	AFA WITH RTO	0.0815 N(14) SIG .391	ITA WITH TX	-0.3275 N(14) SIG .127	ITA WITH PBT	0.3758 N(14) SIG .093	ITA WITH RTO	0.6107 N(15) SIG .008
LS WITH PBT	-0.0286 N(15) SIG .460	LS WITH RTO	-0.0882 N(16) SIG .373	LS WITH AFA	0.4515 N(14) SIG .053	LS WITH ITA	0.0357 N(15) SIG .450	LS WITH DRS	0.6269 N(16) SIG .005		
LS WITH TP	-0.5353 N(16) SIG .016	LS WITH TX	0.1143 N(15) SIG .343	LS WITH CI	-0.0471 N(16) SIG .431	TP WITH TX	0.3429 N(15) SIG .105	TP WITH CI	0.3753 N(16) SIG .076	TX WITH CI	0.0715 N(15) SIG .400
DOE WITH RTO	-0.5235 N(16) SIG .019										

YEAR 3

- - - - - - - - - - - - - - SPEARMAN CORRELATION COEFFICIENTS - - - - - - - - - - - - -

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.3294 N(20) SIG .078	TX WITH RTO	-0.1730 N(20) SIG .233								
AFA WITH TX	-0.1345 N(15) SIG .316	AFA WITH PBT	0.2222 N(15) SIG .213	AFA WITH RTO	0.3943 N(15) SIG .073	ITA WITH TX	0.2949 N(15) SIG .143	ITA WITH PBT	0.3429 N(15) SIG .165	ITA WITH RTO	0.1714 N(15) SIG .271
LS WITH PBT	-0.3684 N(20) SIG .055	LS WITH RTO	-0.1684 N(20) SIG .239	LS WITH AFA	0.2258 N(15) SIG .209	LS WITH ITA	0.0714 N(15) SIG .400	LS WITH DRS	0.5047 N(20) SIG .012		
LS WITH TP	-0.6060 N(20) SIG .002	LS WITH TX	-0.1926 N(20) SIG .208	LS WITH CI	-0.6195 N(20) SIG .002	TP WITH TX	0.5002 N(20) SIG .012	TP WITH CI	0.6421 N(20) SIG .001	TX WITH CI	0.3543 N(20) SIG .063
DOE WITH RTO	-0.6857 N(20) SIG .001										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	0.2794 N(14) SIG .167	TX WITH RTO	-0.2750 N(14) SIG .171								
AFA WITH TX	-0.5532 N(10) SIG .049	AFA WITH PBT	0.1030 N(10) SIG .388	AFA WITH RTO	0.4182 N(10) SIG .115	ITA WITH TX	0.2188 N(10) SIG .272	ITA WITH PBT	0.6727 N(10) SIG .017	ITA WITH RTO	0.3455 N(10) SIG .164
LS WITH PBT	-0.3626 N(14) SIG .101	LS WITH RTO	-0.1209 N(14) SIG .340	LS WITH AFA	0.2848 N(10) SIG .213	LS WITH ITA	-0.0303 N(10) SIG .467	LS WITH DRS	0.4901 N(14) SIG .038		
LS WITH TP	-0.6879 N(14) SIG .003	LS WITH TX	-0.2904 N(14) SIG .157	LS WITH CI	-0.6308 N(14) SIG .008	TP WITH TX	0.5017 N(14) SIG .034	TP WITH CI	0.8505 N(14) SIG .001	TX WITH CI	0.3784 N(14) SIG .091
DOE WITH RTO	-0.6000 N(14) SIG .012										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.5382 N(16) SIG .016	TX WITH RTO	0.0853 N(16) SIG .377								
AFA WITH TX	0.0055 N(13) SIG .493	AFA WITH PBT	0.1934 N(13) SIG .263	AFA WITH RTO	0.1768 N(13) SIG .282	ITA WITH TX	0.3242 N(13) SIG .140	ITA WITH PBT	0.3901 N(13) SIG .094	ITA WITH RTO	0.2418 N(13) SIG .213
LS WITH PBT	-0.4441 N(16) SIG .042	LS WITH RTO	-0.3706 N(16) SIG .079	LS WITH AFA	0.2044 N(13) SIG .251	LS WITH ITA	0.0769 N(13) SIG .401	LS WITH DRS	0.4971 N(16) SIG .025		
LS WITH TP	-0.5559 N(16) SIG .013	LS WITH TX	-0.0735 N(16) SIG .393	LS WITH CI	-0.5176 N(16) SIG .020	TP WITH TX	0.5676 N(16) SIG .011	TP WITH CI	0.6324 N(16) SIG .004	TX WITH CI	0.2000 N(16) SIG .229
DOE WITH RTO	-0.7559 N(16) SIG .001										

YEAR 4

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.3099 N(20) SIG .092	TX WITH RTO	-0.2710 N(20) SIG .124								
AFA WITH TX	0.0474 N(19) SIG .424	AFA WITH PBT	0.3281 N(19) SIG .085	AFA WITH RTO	0.2264 N(19) SIG .176	ITA WITH TX	-0.0360 N(19) SIG .442	ITA WITH PBT	0.3632 N(19) SIG .063	ITA WITH RTO	0.3229 N(19) SIG .089
LS WITH PBT	-0.2226 N(20) SIG .173	LS WITH RTO	-0.2476 N(20) SIG .146	LS WITH AFA	0.3807 N(19) SIG .054	LS WITH ITA	0.2246 N(19) SIG .178	LS WITH DRS	0.4566 N(20) SIG .021		
LS WITH TP	-0.7123 N(20) SIG .001	LS WITH TX	-0.0564 N(20) SIG .407	LS WITH CI	-0.5372 N(20) SIG .007	TP WITH TX	0.4372 N(20) SIG .027	TP WITH CI	0.5423 N(20) SIG .007	TX WITH CI	0.2145 N(20) SIG .182
DOE WITH RTO	-0.5719 N(20) SIG .004										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	0.4505 N(14) SIG .053	TX WITH RTO	-0.2662 N(14) SIG .179								
AFA WITH TX	0.0330 N(13) SIG .457	AFA WITH PBT	0.1868 N(13) SIG .271	AFA WITH RTO	0.1484 N(13) SIG .314	ITA WITH TX	0.2692 N(13) SIG .187	ITA WITH PBT	0.1374 N(13) SIG .327	ITA WITH RTO	0.0000 N(13) SIG .500
LS WITH PBT	-0.3143 N(14) SIG .137	LS WITH RTO	-0.2552 N(14) SIG .189	LS WITH AFA	0.3681 N(13) SIG .108	LS WITH ITA	0.3681 N(13) SIG .108	LS WITH DRS	0.3275 N(14) SIG .127		
LS WITH TP	-0.7495 N(14) SIG .001	LS WITH TX	-0.0549 N(14) SIG .426	LS WITH CI	-0.5259 N(14) SIG .027	TP WITH TX	0.5429 N(14) SIG .022	TP WITH CI	0.6579 N(14) SIG .005	TX WITH CI	0.3938 N(14) SIG .082
DOE WITH RTO	-0.3476 N(14) SIG .112										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.4121 N(16) SIG .056	TX WITH RTO	-0.1208 N(16) SIG .328								
AFA WITH TX	0.1369 N(16) SIG .307	AFA WITH PBT	0.2500 N(16) SIG .175	AFA WITH RTO	0.1957 N(16) SIG .234	ITA WITH TX	-0.1001 N(16) SIG .356	ITA WITH PBT	0.3618 N(16) SIG .084	ITA WITH RTO	0.3900 N(16) SIG .068
LS WITH PBT	-0.2971 N(16) SIG .132	LS WITH RTO	-0.4312 N(16) SIG .048	LS WITH AFA	0.3529 N(16) SIG .090	LS WITH ITA	0.2647 N(16) SIG .161	LS WITH DRS	0.5882 N(16) SIG .008		
LS WITH TP	-0.7285 N(16) SIG .001	LS WITH TX	0.0868 N(16) SIG .375	LS WITH CI	-0.5460 N(16) SIG .014	TP WITH TX	0.3049 N(16) SIG .125	TP WITH CI	0.7209 N(16) SIG .001	TX WITH CI	0.1149 N(16) SIG .336
DOE WITH RTO	-0.7873 N(16) SIG .001										

YEAR 5

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.1354 N(20) SIG .285	TX WITH RTO	-0.2340 N(20) SIG .160								
AFA WITH TX	0.1729 N(19) SIG .240	AFA WITH PBT	0.5169 N(19) SIG .012	AFA WITH RTO	0.3300 N(19) SIG .084	ITA WITH TX	0.1001 N(19) SIG .342	ITA WITH PBT	0.2643 N(19) SIG .137	ITA WITH RTO	0.1633 N(19) SIG .252
LS WITH PBT	-0.4077 N(20) SIG .037	LS WITH RTO	-0.2768 N(20) SIG .119	LS WITH AFA	0.2053 N(19) SIG .200	LS WITH ITA	0.2255 N(19) SIG .177	LS WITH DRS	0.1400 N(20) SIG .278		
LS WITH TP	-0.8030 N(20) SIG .001	LS WITH TX	-0.3580 N(20) SIG .061	LS WITH CI	-0.6220 N(20) SIG .002	TP WITH TX	0.4062 N(20) SIG .038	TP WITH CI	0.5498 N(20) SIG .006	TX WITH CI	0.2656 N(20) SIG .129
DOE WITH RTO	-0.4949 N(20) SIG .013										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	0.1276 N(14) SIG .332	TX WITH RTO	-0.3275 N(14) SIG .127								
AFA WITH TX	0.0110 N(14) SIG .485	AFA WITH PBT	0.2816 N(14) SIG .165	AFA WITH RTO	0.1165 N(14) SIG .346	ITA WITH TX	-0.2068 N(14) SIG .239	ITA WITH PBT	0.0881 N(14) SIG .382	ITA WITH RTO	0.1056 N(14) SIG .360
LS WITH PBT	-0.5567 N(14) SIG .019	LS WITH RTO	-0.3231 N(14) SIG .130	LS WITH AFA	0.2264 N(14) SIG .218	LS WITH ITA	0.3982 N(14) SIG .079	LS WITH DRS	-0.0374 N(14) SIG .449		
LS WITH TP	-0.8725 N(14) SIG .001	LS WITH TX	-0.2703 N(14) SIG .175	LS WITH CI	-0.5963 N(14) SIG .012	TP WITH TX	0.2835 N(14) SIG .163	TP WITH CI	0.6161 N(14) SIG .009	TX WITH CI	0.5875 N(14) SIG .014
DOE WITH RTO	-0.3714 N(14) SIG .096										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.3974 N(16) SIG .064	TX WITH RTO	0.0088 N(16) SIG .487								
AFA WITH TX	0.1215 N(15) SIG .333	AFA WITH PBT	0.5893 N(15) SIG .010	AFA WITH RTO	0.4429 N(15) SIG .049	ITA WITH TX	0.2324 N(15) SIG .202	ITA WITH PBT	0.3500 N(15) SIG .100	ITA WITH RTO	0.2036 N(15) SIG .233
LS WITH PBT	-0.4118 N(16) SIG .057	LS WITH RTO	-0.3029 N(16) SIG .127	LS WITH AFA	0.2214 N(15) SIG .214	LS WITH ITA	0.0500 N(15) SIG .430	LS WITH DRS	0.2134 N(16) SIG .214		
LS WITH TP	-0.7706 N(16) SIG .001	LS WITH TX	-0.4842 N(16) SIG .029	LS WITH CI	-0.6824 N(16) SIG .002	TP WITH TX	0.5548 N(16) SIG .013	TP WITH CI	0.6412 N(16) SIG .004	TX WITH CI	0.2222 N(16) SIG .204
DOE WITH RTO	-0.6559 N(16) SIG .003										

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.3355 N(20) SIG .074	TX WITH RTO	-0.2038 N(20) SIG .194								
AFA WITH TX	-0.1308 N(19) SIG .297	AFA WITH PBT	0.3300 N(19) SIG .084	AFA WITH RTO	0.5959 N(19) SIG .004	ITA WITH TX	0.0281 N(19) SIG .455	ITA WITH PBT	0.2649 N(19) SIG .137	ITA WITH RTO	0.3772 N(19) SIG .056
LS WITH PBT	-0.1076 N(20) SIG .326	LS WITH RTO	-0.0075 N(20) SIG .487	LS WITH AFA	0.2072 N(19) SIG .197	LS WITH ITA	0.6082 N(19) SIG .003	LS WITH DRS	0.6011 N(20) SIG .003		
LS WITH TP	-0.6955 N(20) SIG .001	LS WITH TX	-0.2021 N(20) SIG .196	LS WITH CI	-0.6142 N(20) SIG .002	TP WITH TX	0.3627 N(20) SIG .058	TP WITH CI	0.5087 N(20) SIG .011	TX WITH CI	0.5730 N(20) SIG .004
DOE WITH RTO	-0.4782 N(20) SIG .016										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	0.4224 N(14) SIG .065	TX WITH RTO	-0.2838 N(14) SIG .163								
AFA WITH TX	-0.3191 N(13) SIG .144	AFA WITH PBT	0.2308 N(13) SIG .224	AFA WITH RTO	0.5989 N(13) SIG .015	ITA WITH TX	-0.1155 N(13) SIG .354	ITA WITH PBT	-0.0989 N(13) SIG .374	ITA WITH RTO	0.1209 N(13) SIG .347
LS WITH PBT	-0.4075 N(14) SIG .074	LS WITH RTO	-0.2313 N(14) SIG .213	LS WITH AFA	0.0165 N(13) SIG .479	LS WITH ITA	0.6300 N(13) SIG .011	LS WITH DRS	0.5303 N(14) SIG .026		
LS WITH TP	-0.8568 N(14) SIG .001	LS WITH TX	-0.1466 N(14) SIG .308	LS WITH CI	-0.5711 N(14) SIG .016	TP WITH TX	0.3740 N(14) SIG .094	TP WITH CI	0.6689 N(14) SIG .004	TX WITH CI	0.6156 N(14) SIG .010
DOE WITH RTO	-0.3275 N(14) SIG .127										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.4106 N(16) SIG .057	TX WITH RTO	0.0456 N(16) SIG .433								
AFA WITH TX	0.1038 N(15) SIG .356	AFA WITH PBT	0.5130 N(15) SIG .025	AFA WITH RTO	0.5737 N(15) SIG .013	ITA WITH TX	0.1430 N(15) SIG .306	ITA WITH PBT	0.5071 N(15) SIG .027	ITA WITH RTO	0.5250 N(15) SIG .022
LS WITH PBT	-0.0692 N(16) SIG .400	LS WITH RTO	0.0235 N(16) SIG .466	LS WITH AFA	0.1501 N(15) SIG .297	LS WITH ITA	0.4500 N(15) SIG .046	LS WITH DRS	0.5943 N(16) SIG .008		
LS WITH TP	-0.6274 N(16) SIG .005	LS WITH TX	-0.3240 N(16) SIG .110	LS WITH CI	-0.7255 N(16) SIG .001	TP WITH TX	0.5081 N(16) SIG .022	TP WITH CI	0.6431 N(16) SIG .004	TX WITH CI	0.4533 N(16) SIG .039
DOE WITH RTO	-0.6412 N(16) SIG .004										

Appendix 17.8

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.5203 N(20) SIG .009	TX WITH RTO	0.0030 N(20) SIG .495								
AFA WITH TX	-0.0939 N(19) SIG .351	AFA WITH PBT	0.0948 N(19) SIG .350	AFA WITH RTO	0.2703 N(19) SIG .132	ITA WITH TX	0.0658 N(19) SIG .394	ITA WITH PBT	0.3177 N(19) SIG .093	ITA WITH RTO	0.4458 N(19) SIG .028
LS WITH PBT	-0.2617 N(20) SIG .133	LS WITH RTO	-0.2342 N(20) SIG .112	LS WITH AFA	0.6292 N(19) SIG .002	LS WITH ITA	0.2405 N(19) SIG .161	LS WITH DRS	0.3445 N(20) SIG .068		
LS WITH TP	-0.7098 N(20) SIG .001	LS WITH TX	-0.2511 N(20) SIG .143	LS WITH CI	-0.4545 N(20) SIG .022	TP WITH TX	0.4030 N(20) SIG .039	TP WITH CI	0.2588 N(20) SIG .135	TX WITH CI	0.2513 N(20) SIG .143
DDE WITH RTO	-0.3218 N(20) SIG .083										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	0.5780 N(14) SIG .015	TX WITH RTO	-0.1297 N(14) SIG .329								
AFA WITH TX	-0.4594 N(13) SIG .057	AFA WITH PBT	-0.5227 N(13) SIG .033	AFA WITH RTO	-0.1596 N(13) SIG .301	ITA WITH TX	-0.2692 N(13) SIG .187	ITA WITH PBT	-0.0549 N(13) SIG .429	ITA WITH RTO	0.2582 N(13) SIG .197
LS WITH PBT	-0.6044 N(14) SIG .011	LS WITH RTO	-0.5912 N(14) SIG .013	LS WITH AFA	0.6190 N(13) SIG .012	LS WITH ITA	0.0495 N(13) SIG .436	LS WITH DRS	0.2088 N(14) SIG .237		
LS WITH TP	-0.9209 N(14) SIG .001	LS WITH TX	-0.2791 N(14) SIG .167	LS WITH CI	-0.3552 N(14) SIG .100	TP WITH TX	0.4945 N(14) SIG .036	TP WITH CI	0.4686 N(14) SIG .045	TX WITH CI	0.3938 N(14) SIG .082
DDE WITH RTO	-0.0462 N(14) SIG .438										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.3412 N(16) SIG .098	TX WITH RTO	0.0618 N(16) SIG .410								
AFA WITH TX	0.1036 N(15) SIG .357	AFA WITH PBT	0.2679 N(15) SIG .167	AFA WITH RTO	0.4893 N(15) SIG .032	ITA WITH TX	0.3450 N(15) SIG .104	ITA WITH PBT	0.5201 N(15) SIG .023	ITA WITH RTO	0.4558 N(15) SIG .044
LS WITH PBT	-0.2941 N(16) SIG .134	LS WITH RTO	-0.0794 N(16) SIG .385	LS WITH AFA	0.6250 N(15) SIG .006	LS WITH ITA	0.1752 N(15) SIG .266	LS WITH DRS	0.5931 N(16) SIG .008		
LS WITH TP	-0.6294 N(16) SIG .004	LS WITH TX	-0.2706 N(16) SIG .155	LS WITH CI	-0.4253 N(16) SIG .050	TP WITH TX	0.4176 N(16) SIG .054	TP WITH CI	0.1737 N(16) SIG .260	TX WITH CI	0.0809 N(16) SIG .383
DDE WITH RTO	-0.3824 N(16) SIG .072										

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.4876 N(20) SIG .015	TX WITH RTO	0.0338 N(20) SIG .444								
AFA WITH TX	0.2954 N(20) SIG .103	AFA WITH PBT	0.2258 N(20) SIG .169	AFA WITH RTO	0.1407 N(20) SIG .277	ITA WITH TX	-0.1566 N(20) SIG .255	ITA WITH PBT	0.4093 N(20) SIG .037	ITA WITH RTO	0.4705 N(20) SIG .018
LS WITH PBT	-0.3317 N(20) SIG .077	LS WITH RTO	-0.4226 N(20) SIG .032	LS WITH AFA	0.3409 N(20) SIG .071	LS WITH ITA	0.0565 N(20) SIG .407	LS WITH DRS	0.4389 N(20) SIG .014		
LS WITH TP	-0.6596 N(20) SIG .001	LS WITH TX	0.0008 N(20) SIG .499	LS WITH CI	-0.5970 N(20) SIG .003	TP WITH TX	0.4545 N(20) SIG .022	TP WITH CI	0.3866 N(20) SIG .046	TX WITH CI	0.0790 N(20) SIG .370
DOE WITH RTO	-0.3332 N(20) SIG .076										
MANUFACTURING AND ENGINEERING FIRMS											
AFA WITH TX	0.1112 N(14) SIG .353	AFA WITH PBT	-0.0485 N(14) SIG .435	AFA WITH RTO	0.0132 N(14) SIG .482	ITA WITH TX	-0.2952 N(14) SIG .153	ITA WITH PBT	0.4604 N(14) SIG .049	ITA WITH RTO	0.5259 N(14) SIG .027
LS WITH PBT	-0.8097 N(14) SIG .001	LS WITH RTO	-0.6747 N(14) SIG .004	LS WITH AFA	-0.0264 N(14) SIG .464	LS WITH ITA	-0.1364 N(14) SIG .321	LS WITH DRS	0.3143 N(14) SIG .137		
LS WITH TP	-0.8725 N(14) SIG .001	LS WITH TX	-0.0836 N(14) SIG .388	LS WITH CI	-0.5297 N(14) SIG .026	TP WITH TX	0.3300 N(14) SIG .125	TP WITH CI	0.5824 N(14) SIG .014	TX WITH CI	0.4752 N(14) SIG .043
DOE WITH RTO	-0.1672 N(14) SIG .284										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.1751 N(16) SIG .258	TX WITH RTO	-0.4618 N(16) SIG .036								
AFA WITH TX	0.2529 N(16) SIG .172	AFA WITH PBT	0.2487 N(16) SIG .176	AFA WITH RTO	0.2294 N(16) SIG .196	ITA WITH TX	-0.3552 N(16) SIG .088	ITA WITH PBT	0.4285 N(16) SIG .049	ITA WITH RTO	0.4878 N(16) SIG .028
LS WITH PBT	-0.2193 N(16) SIG .207	LS WITH RTO	-0.3706 N(16) SIG .079	LS WITH AFA	0.3941 N(16) SIG .065	LS WITH ITA	-0.1061 N(16) SIG .348	LS WITH DRS	0.6529 N(16) SIG .003		
LS WITH TP	-0.6269 N(16) SIG .005	LS WITH TX	0.3118 N(16) SIG .120	LS WITH CI	-0.5000 N(16) SIG .024	TP WITH TX	0.1957 N(16) SIG .234	TP WITH CI	0.3385 N(16) SIG .100	TX WITH CI	-0.1265 N(16) SIG .320
DOE WITH RTO	-0.7588 N(16) SIG .001										

Appendix 17.10

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.3227 N(20) SIG .083	TX WITH RTO	-0.3896 N(20) SIG .045								
AFA WITH TX	0.0059 N(16) SIG .491	AFA WITH PBT	0.1176 N(16) SIG .332	AFA WITH RTO	-0.1235 N(16) SIG .324	ITA WITH TX	-0.2252 N(16) SIG .201	ITA WITH PBT	0.2046 N(16) SIG .224	ITA WITH RTO	0.3076 N(16) SIG .123
LS WITH PBT	-0.1768 N(20) SIG .228	LS WITH RTO	-0.0293 N(20) SIG .451	LS WITH AFA	0.2618 N(16) SIG .164	LS WITH ITA	0.7005 N(16) SIG .001	LS WITH DRS	0.5957 N(20) SIG .003		
LS WITH TP	-0.6965 N(20) SIG .001	LS WITH TX	-0.3310 N(20) SIG .077	LS WITH CI	-0.5901 N(20) SIG .003	TP WITH TX	0.5414 N(20) SIG .007	TP WITH CI	0.5982 N(20) SIG .003	TX WITH CI	0.2852 N(20) SIG .111
DOE WITH RTO	-0.3579 N(20) SIG .061										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	0.4681 N(14) SIG .046	TX WITH RTO	-0.1297 N(14) SIG .329								
AFA WITH TX	0.0070 N(12) SIG .491	AFA WITH PBT	-0.2098 N(12) SIG .256	AFA WITH RTO	-0.4336 N(12) SIG .080	ITA WITH TX	-0.2448 N(12) SIG .222	ITA WITH PBT	0.0210 N(12) SIG .474	ITA WITH RTO	0.1469 N(12) SIG .324
LS WITH PBT	-0.6095 N(14) SIG .010	LS WITH RTO	-0.3542 N(14) SIG .107	LS WITH AFA	0.0070 N(12) SIG .491	LS WITH ITA	0.6364 N(12) SIG .013	LS WITH DRS	0.6073 N(14) SIG .011		
LS WITH TP	-0.8185 N(14) SIG .001	LS WITH TX	-0.4070 N(14) SIG .374	LS WITH CI	-0.4956 N(14) SIG .036	TP WITH TX	0.6967 N(14) SIG .003	TP WITH CI	0.7657 N(14) SIG .001	TX WITH CI	0.3982 N(14) SIG .079
DOE WITH RTO	-0.1982 N(14) SIG .248										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.0633 N(16) SIG .408	TX WITH RTO	-0.6147 N(16) SIG .006								
AFA WITH TX	0.1538 N(13) SIG .308	AFA WITH PBT	0.0824 N(13) SIG .394	AFA WITH RTO	-0.2418 N(13) SIG .213	ITA WITH TX	-0.3549 N(13) SIG .117	ITA WITH PBT	0.0165 N(13) SIG .479	ITA WITH RTO	0.1596 N(13) SIG .301
LS WITH PBT	-0.2472 N(16) SIG .178	LS WITH RTO	-0.1500 N(16) SIG .290	LS WITH AFA	0.1374 N(13) SIG .327	LS WITH ITA	0.6410 N(13) SIG .009	LS WITH DRS	0.7176 N(16) SIG .001		
LS WITH TP	-0.7382 N(16) SIG .001	LS WITH TX	-0.2412 N(16) SIG .184	LS WITH CI	-0.4919 N(16) SIG .026	TP WITH TX	0.3500 N(16) SIG .092	TP WITH CI	0.4963 N(16) SIG .025	TX WITH CI	-0.0133 N(16) SIG .481
DOE WITH RTO	-0.3765 N(16) SIG .075										

Appendix 17.11

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	-0.0950 N(20) SIG .361	TX WITH RTO	-0.5077 N(20) SIG .011								
AFA WITH TX	-0.2801 N(20) SIG .116	AFA WITH PBT	0.4960 N(20) SIG .013	AFA WITH RTO	0.5518 N(20) SIG .006	ITA WITH TX	0.0181 N(20) SIG .470	ITA WITH PBT	0.5098 N(20) SIG .011	ITA WITH RTO	0.4782 N(20) SIG .016
LS WITH PBT	-0.2512 N(20) SIG .143	LS WITH RTO	-0.0023 N(20) SIG .496	LS WITH AFA	0.1608 N(20) SIG .249	LS WITH ITA	-0.1219 N(20) SIG .304	LS WITH DRS	0.5370 N(20) SIG .007		
LS WITH TP	-0.6333 N(20) SIG .001	LS WITH TX	-0.4650 N(20) SIG .019	LS WITH CI	-0.2147 N(20) SIG .182	TP WITH TX	0.4212 N(20) SIG .032	TP WITH CI	0.0919 N(20) SIG .350	TX WITH CI	0.0347 N(20) SIG .442
DOE WITH RTO	-0.6431 N(20) SIG .001										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	-0.2442 N(14) SIG .200	TX WITH RTO	-0.6491 N(14) SIG .006								
AFA WITH TX	-0.3256 N(14) SIG .128	AFA WITH PBT	0.3187 N(14) SIG .133	AFA WITH RTO	0.3802 N(14) SIG .090	ITA WITH TX	0.0220 N(14) SIG .470	ITA WITH PBT	0.4813 N(14) SIG .041	ITA WITH RTO	0.4593 N(14) SIG .049
LS WITH PBT	-0.4286 N(14) SIG .063	LS WITH RTO	-0.0593 N(14) SIG .420	LS WITH AFA	0.1033 N(14) SIG .363	LS WITH ITA	-0.1560 N(14) SIG .297	LS WITH DRS	0.4989 N(14) SIG .035		
LS WITH TP	-0.9385 N(14) SIG .001	LS WITH TX	-0.4070 N(14) SIG .074	LS WITH CI	-0.1744 N(14) SIG .275	TP WITH TX	0.3938 N(14) SIG .082	TP WITH CI	0.3687 N(14) SIG .097	TX WITH CI	0.0906 N(14) SIG .379
DOE WITH RTO	-0.5853 N(14) SIG .014										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.0250 N(16) SIG .463	TX WITH RTO	-0.4371 N(16) SIG .045								
AFA WITH TX	-0.4024 N(16) SIG .061	AFA WITH PBT	0.5641 N(16) SIG .011	AFA WITH RTO	0.6819 N(16) SIG .002	ITA WITH TX	-0.1192 N(16) SIG .339	ITA WITH PBT	0.6500 N(16) SIG .003	ITA WITH RTO	0.7412 N(16) SIG .001
LS WITH PBT	-0.2929 N(16) SIG .135	LS WITH RTO	0.0059 N(16) SIG .491	LS WITH AFA	0.3191 N(16) SIG .114	LS WITH ITA	-0.0942 N(16) SIG .364	LS WITH DRS	0.6299 N(16) SIG .004		
LS WITH TP	-0.5666 N(16) SIG .011	LS WITH TX	-0.5066 N(16) SIG .023	LS WITH CI	-0.2342 N(16) SIG .191	TP WITH TX	0.3797 N(16) SIG .073	TP WITH CI	0.1325 N(16) SIG .312	TX WITH CI	0.2261 N(16) SIG .200
DOE WITH RTO	-0.6461 N(16) SIG .003										

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	-0.5378 N(20) SIG .007	TX WITH RTO	-0.7374 N(20) SIG .001								
AFA WITH TX	-0.5088 N(19) SIG .013	AFA WITH PBT	0.5485 N(19) SIG .008	AFA WITH RTO	0.6396 N(19) SIG .002	ITA WITH TX	-0.4051 N(19) SIG .043	ITA WITH PBT	0.1924 N(19) SIG .215	ITA WITH RTO	0.3607 N(19) SIG .065
LS WITH PBT	-0.1068 N(20) SIG .327	LS WITH RTO	0.0301 N(20) SIG .450	LS WITH AFA	0.2282 N(19) SIG .174	LS WITH ITA	0.6957 N(19) SIG .001	LS WITH DRS	0.5273 N(20) SIG .008		
LS WITH TP	-0.4551 N(20) SIG .022	LS WITH TX	-0.2339 N(20) SIG .160	LS WITH CI	-0.3025 N(20) SIG .097	TP WITH TX	-0.0181 N(20) SIG .470	TP WITH CI	0.1159 N(20) SIG .313	TX WITH CI	-0.0527 N(20) SIG .413
DOE WITH RTO	-0.3971 N(20) SIG .041										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	-0.5604 N(14) SIG .019	TX WITH RTO	-0.8154 N(14) SIG .001								
AFA WITH TX	-0.5545 N(14) SIG .020	AFA WITH PBT	0.3036 N(14) SIG .146	AFA WITH RTO	0.5259 N(14) SIG .027	ITA WITH TX	-0.5039 N(14) SIG .033	ITA WITH PBT	0.2134 N(14) SIG .232	ITA WITH RTO	0.4224 N(14) SIG .066
LS WITH PBT	-0.4242 N(14) SIG .065	LS WITH RTO	-0.2352 N(14) SIG .209	LS WITH AFA	0.1870 N(14) SIG .261	LS WITH ITA	0.6579 N(14) SIG .005	LS WITH DRS	0.4334 N(14) SIG .061		
LS WITH TP	-0.8813 N(14) SIG .001	LS WITH TX	-0.1077 N(14) SIG .357	LS WITH CI	-0.2376 N(14) SIG .207	TP WITH TX	-0.0462 N(14) SIG .438	TP WITH CI	0.1980 N(14) SIG .249	TX WITH CI	-0.1210 N(14) SIG .340
DOE WITH RTO	-0.8367 N(14) SIG .001										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	-0.3059 N(16) SIG .125	TX WITH RTO	-0.5931 N(16) SIG .008								
AFA WITH TX	-0.2714 N(15) SIG .164	AFA WITH PBT	0.4893 N(15) SIG .032	AFA WITH RTO	0.5201 N(15) SIG .023	ITA WITH TX	-0.5666 N(15) SIG .014	ITA WITH PBT	0.1573 N(15) SIG .288	ITA WITH RTO	0.4159 N(15) SIG .062
LS WITH PBT	-0.0941 N(16) SIG .364	LS WITH RTO	0.0824 N(16) SIG .381	LS WITH AFA	0.2429 N(15) SIG .192	LS WITH ITA	0.7364 N(15) SIG .001	LS WITH DRS	0.6176 N(16) SIG .005		
LS WITH TP	-0.5048 N(16) SIG .023	LS WITH TX	-0.4088 N(16) SIG .058	LS WITH CI	-0.2180 N(16) SIG .209	TP WITH TX	0.1781 N(16) SIG .255	TP WITH CI	0.2461 N(16) SIG .179	TX WITH CI	0.1576 N(16) SIG .280
DOE WITH RTO	-0.4341 N(16) SIG .046										

Appendix 17.14

Pearson's Correlation Results - for Average Ratios

1964-1974

(Sample - All Firms)
(N = 20)

Variables	r	Level of significance
TX v PBT	0.44	0.03
TX v RTO	-0.03	0.45
LS v PBT	-0.27	0.12
LS v RTO	-0.13	0.29
LS v TX	-0.33	0.08
LS v TP	-0.67	0.001
LS v CI	-0.51	0.01
LS v DRS	0.18	0.20
CI v TP	0.56	0.01
TP v TX	0.58	0.004
CI v TX	0.37	0.06
DOE v RTO	-0.38	0.05

AVERAGES

SPEARMAN CORRELATION COEFFICIENTS

VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR		VARIABLE PAIR	
ALL FIRMS											
TX WITH PBT	0.6353 N(20) SIG .001	TX WITH RTO	0.2926 N(20) SIG .105								
LS WITH PBT	-0.2551 N(20) SIG .139	LS WITH RTO	-0.1015 N(20) SIG .335	LS WITH TX	-0.3890 N(20) SIG .045	LS WITH TP	-0.6501 N(20) SIG .001	LS WITH CI	-0.5303 N(20) SIG .008	LS WITH DRS	0.2445 N(20) SIG .149
TP WITH TX	0.6208 N(20) SIG .002	TP WITH CI	0.4212 N(20) SIG .032								
TX WITH CI	0.4430 N(20) SIG .025										
DOE WITH RTO	-0.3699 N(20) SIG .054										
MANUFACTURING AND ENGINEERING FIRMS											
TX WITH PBT	0.7225 N(14) SIG .002	TX WITH RTO	0.1892 N(14) SIG .259								
LS WITH PBT	-0.7269 N(14) SIG .002	LS WITH RTO	-0.3806 N(14) SIG .090	LS WITH TX	-0.4163 N(14) SIG .069	LS WITH TP	-0.9483 N(14) SIG .001	LS WITH CI	-0.7261 N(14) SIG .002	LS WITH DRS	0.0440 N(14) SIG .441
TP WITH TX	0.5369 N(14) SIG .024	TP WITH CI	0.8198 N(14) SIG .001								
TX WITH CI	0.7635 N(14) SIG .001										
DOE WITH RTO	-0.4286 N(14) SIG .063										
FIRMS NOT REPORTING LOSSES											
TX WITH PBT	0.5493 N(16) SIG .014	TX WITH RTO	0.3856 N(16) SIG .070								
LS WITH PBT	-0.3017 N(16) SIG .128	LS WITH RTO	-0.2294 N(16) SIG .196	LS WITH TX	-0.5048 N(16) SIG .023	LS WITH TP	-0.6755 N(16) SIG .002	LS WITH CI	-0.4941 N(16) SIG .026	LS WITH DRS	0.4029 N(16) SIG .061
TP WITH TX	0.6451 N(16) SIG .003	TP WITH CI	0.4886 N(16) SIG .027								
TX WITH CI	0.5224 N(16) SIG .019										
DOE WITH RTO	-0.4147 N(16) SIG .055										