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Development Aid Taxation Act Amendment

by Professor Hans Günther Meissner, Cologne *

One of the important tasks which the new Federal Government will have to tackle during 1973 is the amendment of the *Entwicklungshilfe-Steuer-gesetz* (Development Aid Taxation Act). The following article reviews the aims of the Act and suggests modifications necessary for improving its effectiveness.

Shortly before its dissolution in September 1972, the last Bundestag has voted for extending the Development Aid Taxation Act for another year until December 31, 1973. In prolonging the run of this Act for such a brief period of one year only, Parliament wanted to indicate that a true policy decision whether to let the writ of the Development Aid Taxation Act since its first introduction in 1963 and its amendment in 1968 run on with or without changes had been impossible during the shortened life-span of the legislature. It has therefore passed on this task to the future Bundestag, which will very soon have to clarify its fundamental attitude to the principles governing investment aid to less developed countries (LDCs).

Various reasons have been adduced for criticising both the rules laid down by the Development Aid Taxation Act for development aid, and the tools available for such aid. The Federal Government itself, notably its Ministry for Economic Cooperation, have argued that these tools are only of limited use for carrying out the aims of the Federal Government's development policy¹. An extreme example of the Development Aid Taxation Act's questionable utility in benefiting a true development policy has been the possibility of using it for obtaining subsidies for forming a so-called "depreciation company" whose task it is to build new hotels in Tenerife. Business circles, on the other hand, maintain that the tools provided by the Development Aid Taxation Act are insufficient for overcoming the noticeable reluctance of German businesses to invest directly in LDCs². The Association of German Chambers of Industry and

Commerce—DIHT—does not believe that shaping the tools used for dispensing development aid according to the political and development policies of the Federal Government would make it exactly easier for businesses to move in favour of investing in LDCs.

Thus, the discussion about forthcoming amendments of the Development Aid Taxation Act is carried on mainly between the two opposites — of making it more subservient to politics, and of improving its commercial efficiency. It is the purpose of this discussion to evaluate possibilities and aims of a potential Development Aid Taxation Act amendment on the background of these conflicting aims of the legislator and the business community.

Possibilities of Aid

The Development Aid Taxation Act, as it stands, provides for two possibilities of aiding capital investment in LDCs:

□ Depreciation of 15 p.c. on purchasing and/or production costs of capital investments³ in LDCs. This enables the investor to accumulate hidden reserves which attract tax only when they are dissolved. In cases in which the Federal Republic has signed an agreement for avoiding double taxation with any given LDC, this depreciation does not apply because founders' shares in foreign personal partnerships will then not appear in the balance sheets submitted to the German tax authorities — but this increases tax-free reserves by 60 p.c.

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¹ Erhard Eppeler, *Direktinvestitionen als Instrument der Entwicklungspolitik* (Direct Investments as an Instrument of Development Policy), in: *Materialien*, No. 35, pp. 28 et seq., Bonn, May 1972.

² Deutscher Industrie- und Handelstag (Association of German Chambers of Industry and Commerce), *Annual Report*, 1971, pp. 38/39.

³ Under the Development Aid Taxation Act rules, capital investments are: participations in the risk capital of joint-stock companies; loan grants that are similar to such participations; the transfer of operating capital and assets; and founders' shares in personal partnerships.

Tax-free Reserves up to 50 p.c. of invested risk capital minus the depreciation allowance.

These instruments for facilitating aid have a double impact: firstly, they reduce the profit liable to taxation, and by lower taxation they tend to increase the yields of any given investment; secondly, they increase the liquidity of any company so aided, because the principle of tax-free reserves is that of a tax suspension, since tax-free reserves must be gradually dissolved only after six years at annual rates of one sixth. Investors thus save, during the first six years, temporarily 33.6 p.c. of normal taxes, and eventually, through the obligation to dissolve tax-free reserves, allowing for a rate of interest of 6 p.c., 19.8 p.c.⁴

Reduction through Fiscal Practices

The mode of applying the Development Aid Taxation Act regulations becomes contentious⁵ with regard to the reference basis for depreciation. In determining the purchase price or the production costs of participations, it makes no difference, in law, whether these costs are being financed from the investor's own or from borrowed funds and, moreover, it is also irrelevant where borrowed funds originate, even if they are mobilised locally in a given LDC. It is clear that such possibilities directly violate the purpose of the Act which is to increase capital movements from industrialised countries to LDCs. This is why German tax authorities have moved to impose restrictions. In the case of personal partnerships the problem arises, whether the tax-free reserves appear in their balance sheets prepared for the German, or for the LDCs', tax authorities. It is left to the discretion of the taxpayer in which of the two balance sheets he wants to show tax-free reserves. Other questions arise if and when a production plant in an LDC is sold. However, these are problems of fiscal techniques, and they do not touch the fundamental effects of the Act which is to be discussed here.

Up to now, the Development Aid Taxation Act has led to tax remissions of about DM 150 mn, which served to finance total investments of about DM 500 mn.⁶ Since the total of direct German

investments in LDCs amounts to about DM 1,400 mn⁷ (including only net capital participations, and not loans similar to equity shares, and also not founders' shares in "depreciation companies"), the Act has influenced only about one third of German investments in LDCs. It is clear that the decisions to invest have not been influenced to such an extent as the legislator would have wished. It is especially this fact which shows that regulations of the Act should be tied up much more closely to the decisions of businessmen to invest, in order to make its impact on development policies stronger.

Amendment of the Law

Potential amendments should aim at three distinct objectives:

Countries eligible for aid should be selectively classified. It might be possible to establish a sliding scale of aid according to the degree of development reached by the recipient countries — possibly graded according to income per head, so that countries with the lowest income per head would qualify for the highest rate of aid. This would attract more investment capital to the neediest countries. On the other hand, exaggerated aid rates, which largely free any investor of risks for his investment, might lead to the neglect of operational efficiency in the LDC so favoured.

Projects to be aided should also be classified, and preferences established. Proposals serving this purpose have already been made: they suggest that ventures which absorb much labour, and thus create the maximum number of new jobs, ought to be preferred. Aid would then be graduated in proportion to the share of the wage bill in total outgoings of any given venture. But here the problem also arises that on principle unprofitable projects will be promoted, which in the long term cannot exist in view of international competition. Besides, this would necessitate evaluation of individual cases, making for a considerable growth of bureaucracy in doling out aid. Even now, the limited use which has been made of the Development Aid Taxation Act development financing proves that there are inhibitions caused by complex fiscal regulations, whose longer-term impact cannot be exactly foreseen (e.g. because it is always possible that taxation rates might rise).

Another form of favouring selected ventures might be based on the intention of promoting technological progress in LDCs. This should be

⁴ Henry Krägenau, *Entwicklung und Förderung der deutschen Direktinvestitionen (Development and Promotion of German Direct Investments)*, in: Hans-Eckard Scharrer (ed.), *Förderung privater Direktinvestitionen (The Promotion of German Direct Investments)*, pp. 539 et seq., Hamburg, 1972.

⁵ G. Söffling, *Zweifelsfragen zum Entwicklungshilfe-Steuer-gesetz (Doubts About the Development Aid Taxation Act)*, in: *Die Information*, No. 17, 1972, Vol. 26, pp. 783 et seq.

⁶ Gesellschaft zum Studium strukturpolitischer Fragen e.V. (Association for Studying the Problems of Structural Policies); Minutes of Its Advisory Board on Foreign Trade and Development Aid, of April 26, 1972, p. 3.

⁷ *Bundesanzeiger (German Government Gazette)*, No. 65, April 6, 1972.

done by facilitating the transfer of technological and administrative knowhow, even if this knowhow is not transmitted through direct investments but by making technical aid agreements.

□ There should be discrimination between different types of capital investment. The Development Aid Taxation Act ought not to give additional aid to pure "depreciation companies" — a principle applicable to some investments in tourism. The Federal Ministry for Economic Cooperation has already reserved to itself the right to examine the projects submitted, in order to make sure that only such ventures receive aid whose contribution to development policy is incontestable. Acquiring participations in hotels planned in Greece, Portugal, or Spain could then qualify for limited aid only.

On the other hand, as far as this has not yet been done, pure trading companies, consultant engineers, and banks should also benefit from aid.

Difficulties of General Classification

All the three directions in which amendments to the Act could be made run inevitably into difficulties bound up with generalising regulations: To give preference to investments in ventures with a high wage share might lead to a proliferation of unprofitable companies. Discrimination between LDCs will immediately provoke political conflicts, and it also carries the risk that those LDCs which have progressed most rapidly may be excluded from receiving aid. But it is just these countries which offer German investors the optimal chances in world markets. Destroying these incentives might mean that the German business community loses some of its future potential for maintaining its position in international markets. Individual evaluation of projects, again, involves so much bureaucratic red tape that decisions about making investments may be delayed and thus reduce German competitiveness.

This leaves open the question how the Development Aid Taxation Act's incentives for investors could be strengthened in a way that only such investments are favoured which are desirable within the framework of development policy. The strongest incentive possible will be based on using comprehensive and sufficient tools of development aid, which are applied unbureaucratically, though bureaucracy is indispensable as long as development priorities are to be used. That the Act's possibilities have never been fully utilised (not even by big concerns which mainly invest through their foreign holding companies that are outside the scope of the Act) leads to the conclusion that it would be best to proceed generously and unbureaucratically, without paying too anxious attention to the kind of development policy in fashion just at the time. However, development aid should focus on promoting direct investments abroad, including those of pure trading concerns and consultant engineers. This will be the field where the instruments for promoting aid can operate most efficaciously, possibly not so much in directing the decisions to invest for maximum profitability—which depends, in the long term, on marketing prospects of any project—but for maximum liquidity.

Since German companies are, generally speaking, not very highly capitalised, their decisions to invest are more often determined by liquidity aspects than by their profit expectations. Considerations about liquidity are mostly made about the short and medium-term, which means that the chance to form reserves over six years may exert a direct attraction, whilst the question of profit yields, especially in LDCs, is mostly one of long-term prospects.

International Division of Labour

Under the surface—but partly also quite openly—the discussion about amending the Development Aid Taxation Act is influenced by the fear lest an Act favouring German overseas investments will, at the same time, inevitably vitiate the LDCs'



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own chances. Against this, it must be emphasised that the international division of labour has become so widespread that the pattern of foreign trade is now one of multilateral partnership: economic growth of LDCs is indispensable for their own market potential and for their demand for investment goods, whilst growth in industrialised countries leaves gaps in their own home markets where LDCs can sell their products. The common self-interest of both developing and industrialised countries therefore does not make it necessary to promote the prosperity of the one group at the expense of the other, but progress can only be made by a joint system of further common economic development.

This is why the Federal Government and the Bundestag ought not to insist too closely on carrying out their own concepts of development policy, since promoting the export of capital and knowhow by German companies will have indirect effects for fostering development and economic growth. Restricting the Act's support for development ventures would adversely affect the

whole field of indirect promotion of development aid. It is a matter of course that this kind of aid may also have some undesirable side-effects. But part of these effects is not the responsibility of the Federal Government; the governments of individual LDCs have to answer for them. Nor should the Federal Government yield to the temptation to act as an overseer of LDCs by bureaucratising the Development Aid Taxation Act. This could only have nugatory consequences which would go far beyond the limits of marginally undesirable effects caused by development promotion by the Act, as it has so far been applied.

Apart from extending the Act's continuation, any amendment should therefore strengthen the will to make direct German investments in LDCs. The best form for doing this would be to enable German investors to increase their liquid funds. But European LDCs and dependent territories ought to be excluded from this kind of development promotion. In individual cases, projects originating in these countries might still be examined, but these should not be established as precedents.

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