THE TAXATION OF BUSINESS ENTERPRISES AND THE DEVELOPMENT OF FINANCIAL MARKETS IN FINLAND

by Heikki Valvanne and Jaakko Lassila

Institute for Economic Research
Bank of Finland
Series D:4 Mimeographed studies
February 1965

THE TAXATION OF BUSINESS ENTERPRISES AND THE DEVELOPMENT OF FINANCIAL MARKETS IN FINLAND[x]

By Heikki Valvanne and Jaakko Lassila

In recent discussions on maintaining and accelerating the rate of economic growth special emphasis has been put on two factors: increasing productivity and allocating productive resources to fields characterized by growth and ability to compete. Both factors would contribute to increase the total productivity of the economy. This implies an overall need for the development and rationalization of those enterprises, mainly to be found in the small and medium-sized categories, which could contribute to a further improvement in our ability to expand exports and compete effectively with imports. This has become all the more important in recent years, with market integration and elimination of foreign trade restrictions.

Discussions have so far been less concerned with the financial aspects of this process of reallocation and rationalization. A prerequisite for the establishment of new types of industry and rationalization of existing ones is of course that the necessary funds are available to the firms concerned. As the amount and growth of capital is limited, the problem of how to direct funds to these enterprises arises. It is obvious that new capital should to a greater extent serve new, developing industries, and also that existing capital should be channelled to them from those firms which are incapable of further expansion. However, it is not merely a question of obtaining capital, but also of the forms in which it is obtained. When reviewing its financial structure, a firm must consider amongst other things its debt-equity-ratio, and the ratio of long-term to short-term debt. What these ratios

---

[x] This article was originally published in Finnish in Liiketaloudellinen Aikakauskirja (The Journal of Business Economics) No. IV, 1964.

in a firm should be depends on many factors such as the degree of risk in its activities, the life of its investments, the nature of the security it can offer for a loan, and the size of its turnover.

Whether a firm is able to achieve a sound financial structure depends decisively on the structure and way in which the financial markets function. Thus one set of measures which ought to be included in overall plans for economic growth is that which covers the means by which the credit market can best be developed in order that capital is utilized for the most productive investments, and is available to firms in the forms best suited to their needs. These questions, from the viewpoint of the investor, have been considered in another article.[1] Here the same problem will be approached from the entrepreneur´s angle. The discussion will mainly relate to industrial enterprises, but the conclusions reached will generally be applicable to other enterprises.

The public sector influences the operations of financial markets and the financial structure of the business sector through taxation, favouring some forms of finance and penalizing others. This is partly a result of a conscious policy, but often it is unintentional or accidental, since only the fiscal aspect of taxation is in general considered. But whatever the motives, all decisions on taxation affect the activites of enterprises. Considering the economy as a whole, one may ask whether the overall effect of taxation is in accord with the other aims of economic policy. Thus, in this article the writers seek to assess whether the system of taxation influences the availability and channelling of finance to enterprises in the way most likely to promote growth.

The present taxation of enterprises and its effects

If one studies the Finnish income and wealth taxation and the stamp duties[2], the two main forms of taxation as far as firms

---

1. VALVANNE - LASSILA The Need for Reform of the Finnish Capital Market Viewed from the Investor´s Angle, Economic Review 4/1964, Kansallis-Osake-Pankki, Helsinki.

2. VALVANNE - LASSILA Leimaverotus ja rahamarkkinain kehittämispyrkimykset (with English Summary: Stamp Duties and the Development of the Credit Market), The Economic Survey of the Cooperative Credit Society Organization No. 3, 1964.

are concerned, one cannot avoid/the conclusion that legislators have primarily been concerned with the Government's fiscal needs and various social aspects. Little consideration has been given to the economic effects of taxation, still less to the possibilities it offers for directing development. In making the various decisions which together form the present taxation laws, the legislators of different times seem to have paid little or no attention to the concurrent economic aims of the Government. Existing legislation gives no definite indication of how financial markets should develop. In 1961 a committee on tax legislation did consider the need for reform in this respect, but in its final report these points were given a subordinate place.

reaching

We shall first consider how the present income and wealth taxes influence the financial markets and the financing structure of firms.

Interest paid on loans is a deductible item in taxation, whereas dividends, which are also compensation for finance, are not deductible. This means that financing by equity capital is much more expensive than financing by borrowed funds.

We shall illustrate this with an example. The 1964 State income tax rate for companies was 45 per cent, local government took about 12 per cent and church 1 per cent, making a total of 58 per cent. Assume that a company pays 7 1/2 per cent interest on a short-term unmortgaged loan. As the company is allowed to deduct interest paid from its taxable income the amount of tax falls by the equivalent of 58 per cent of the amount of interest; thus the net cost of the loan is only 3.15 per cent. On the other hand, if it pays 7 1/2 per cent dividend on its shares, the actual expenditure remains 7 1/2 per cent, since it is not a deductible item. Thus, financing by equity capital is more than twice as expensive as financing by borrowed capital. - Moreover, a net 3.15 per cent paid as interest on a loan at a time when prices are rising at about the same rate means that the real cost of borrowing is zero.

The present stamp duties practices provide further examples of such discrimination. When a company is founded, or share capital is increased by means of a public issue, a 2 per cent stamp duty is levied on the transaction; on bonus shares the duty is as much as 6 per cent. Against this the stamp duty on bonds issued and on promissory notes is no more than 0.6 per cent and, for instance on 3 or 6 month bills, 0.8 per cent per annum.[1]

Whether or not the loan is secured by mortgage determines how advantageous this method of financing is. At present, a short-term loan unsecured by mortgage is more advantageous than a long-term mortgage loan, because only the first 2 000 marks interest paid on the latter are deductible in local government and church taxation. As interest in excess of 2 000 marks is deductible only in State taxation (tax rate 45 per cent), the company pays a net 4.1 per cent interest on that part of its debt on which interest payments are in excess of 2 000 marks, assuming that the rate of interest on the loans is 7 1/2 per cent. In this case the net cost is about one percentage unit higher than in the previous example, which related to unmortgaged loans.

Thus, owing to differences in tax treatment, equity capital is clearly the most expensive kind of finance for a company and short-term loans not secured by mortgage clearly the cheapest. How such differences have arisen today seems incomprehensible - for instance, the writers have been unable to find out what deep economic insight motivated the rule that interest paid on mortgage loans is deductible only in part in local government taxation of enterprises. Nevertheless, the differences largely explain why companies finance even long-term investments by short-term loans rather than by issues of new shares. Moreover, it is not unusual for small and medium-sized companies to raise funds by borrowing from shareholders, as in such cases all interest payments can be deducted in all taxation.

In addition to these sources of finance, there are some other, still more advantageous possibilities open to enterprises. One is borrowing from their own pension funds and, since the

---

1. See VALVANNE - LASSILA Stamp Duties ...

introduction of the salary and wages earners' pensions schemes (TEL and LEL[1]), from pension insurance institutes. Transfers to a firm's own pension fund or a pension insurance institute are deductible in taxation, and part of the capital can be re-lent by the pensions institute to the firm. For instance, a firm may automatically borrow up to 80 per cent of the premiums paid to an insurance institute operating under TEL at a rate of interest of 5 per cent per annum. As interest paid on the loan is deductible, the company actually pays 2.1 per cent a year net interest on the loan, assuming a total tax rate of 58 per cent.

Most advantageous of all is the self-generation of funds made possible by the very liberal depreciation allowances for fixed assets, and by complete freedom to undervalue inventories. At present buildings and equipment can be written off in a considerably shorter time than is warranted by their technical and economic depreciation. This provides an appreciable reserve which will not appear as a profit until the asset is wholly written off. In practice, however, such reserves can be maintained for a very long time - indefinitely in theory - if the firm continually makes new investments to an extent sufficient to prevent the amount of annual depreciation falling. With the total tax rate as high as 58 per cent, it is understandable that the firms make every effort to keep these reserves intact. This obviously gives rise to the practice whereby enterprises, which are actually incapable of further expansion in their own fields, will make such secondary investments outside their own spheres whose "profitability" lies merely in the possibility of delaying the appearance of hidden reserves as taxable income. This example, showing how such investments channel the funds available in the wrong direction thus raises the question as to whether tax legislation should be amended so as to encourage investment in profitable production of any kind in other firms. The fact that investment in new subsidiaries or in share issues of existing companies or similar assets, which would transfer funds to new expanding industries, cannot be written off, pre-

---

1. See ULLA BREDENBERG The Employment Pensions Scheme in Finland, Bank of Finland Monthly Bulletin No. 11, 1964.

vents the funds available serving total industrial growth.

Like the regulations covering depreciation, those on the valuation of inventories are exceedingly liberal by international standards. Since current assets can be freely undervalued, reserves are created which can in theory be hidden - again indefinitely - and even be increased if inventories are continuously augmented, which is easily done in a firm undergoing vigorous expansion. Here too, one may ask whether the current taxation principles do not influence the extent and timing of inventory investment in a way which does not correspond to the needs of the firm, and is contrary to the long-run economic and cyclical interests of the economy.

Financial structure of firms

Table 1 is based on the official statistics of the profit and loss and balance sheet accounts of industry in 1962. These give a break-down of assets and liabilities of industrial establishments, divided into three groups according to the size of turnover.

Table 1. Combined balance sheet of Finnish industry at the end of 1962

Million marks

	Companies with a turnover of			
	- 0.49	0.5-4.0	5 -	Total
A s s e t s	m.mk	m.mk	m.mk	
Financial assets	126	447	2 026	2 599
Inventories	106	336	1 165	1 607
Fixed assets	276	796	4 746	5 818
Other assets	12	31	166	209
Total	520	1 610	8 103	10 233
L i a b i l i t i e s				
Short-term loans	212	723	2 693	3 628
Long-term loans	151	384	3 030	3 565
Total debt	363	1 107	5 723	7 193
Share capital	68	149	1 271	1 488
Other equity capital	89	354	1 109	1 552
Total equity	157	503	2 380	3 040
Total	520	1 610	8 103	10 233
Debt/equity	2.31	2.20	2.40	2.37
Equity/share capital	2.31	3.38	1.87	2.04

The table indicates that by far the greater part of disposable funds is accounted for by borrowed capital. The average debt-equity-ratio of total industry is 2.37. The ratio is smallest in the second group and greatest in the third, which has an annual turnover of more than 5 million marks. A comparison between total equity and the formal share capital reveals that "other equity capital", that is to say retained profits, plays a more important part than share capital in the financing of industry. The ratio is by far the highest in the second group (3.38); in industry as a whole share capital is about the same size as the visible reserves. However, it should be noted that increases in share capital since the war have mainly taken the form of bonus issues.

Regarding the composition of the debt, short-term loans exceed long-term loans in the groups with small and medium-sized turnovers and for industry as a whole, although in the group with the largest turnovers, long-term loans predominate. The situation seems to be least sound in the second group, where short-term debt is almost double long-term debt. However, it should be kept in mind that due to the credit policy of banks and the present system of taxation, a considerable part of the formally short-term loans are in effect long-term, and further that the long-term debt includes borrowing from the companies' own pension funds, this totalled 383 million marks at the end of 1962. Loans from p nsion insurance institutes amounted to no more than 1 million marks, as the TEL system had only become operative on July 1, 1962.

The figures quoted are based mainly on published balance sheets and therefore do not give a correct picture either of the composition of assets, or of the financial structure of industry. As was stated above, inventories are considerably undervalued. Similarly the value of fixed assets is far too low, partly because it has not followed the rise in prices, partly because of the very generous depreciation allowances granted since 1956. Correspondingly the liabilities do not show the capital reserve these reserves represent.

Table 2 gives an adjusted picture of the combined balance sheets of industry. Assets now include the reserves formed by undervaluation of inventories and by depreciation of fixed assets in excess of their technical and economic depreciation, while liabilities are raised correspondingly to indicate this capital reserve. It would not be correct to enter all this as equity capital, since such open reserves would automatically be taxed under the present system. Therefore in the table 58 per cent (= total tax rate) of these reserves have been included among debts, the rest being included in equity.

In estimating the hidden inventory reserve the writers had access to a fairly representative sample of medium-sized enterprises in different fields of production. On the basis of this sample undervaluation was assumed to be 50 per cent of the actual value of inventories in the case of small and medium-sized firms. As the information available indicates that large companies undervalue their inventories still more - or at least did so in 1962 - the percentage was assumed to be 70 in the third group.

The estimate of depreciation of fixed assets was based on a study of the financial structure of Finnish industry.[1] According to this the weighted annual technical and economic depreciation is 7 per cent of the purchase value. This agrees more or less with pre-1956 practices which allowed no extra depreciation. In table 2 depreciation in excess of 7 per cent has been added to assets and the corresponding capital to liabilities, divided between debts and equity on the same principles as were applied above to inventories. These adjustment items are shown separately in their respective groups.

---

1. GUSTAV MATTSON Industriens finansieringsstruktur i Finland åren 1947-1960 (with English Summary: Structure of Financing in Finnish Industry 1947-1960), The Economic Research Institute of Finnish Industry, Series B 12, Helsinki 1962, p. 49.

Table 2. Adjusted balance sheet of Finnish industry at the end of 1962

Million marks

	Companies with a Turnover of - 0.49 m.mk	0.5-4.9 m.mk	5 - m.mk	Total
A s s e t s				
Financial assets	126	447	2 026	2 599
Inventories	106	336	1 165	1 607
Inventory valuation adjustment	106	336	2 718	3 160
Fixed assets	276	796	4 746	5 818
Depreciation adjustment	45	203	1 486	1 734
Other assets	12	31	166	209
Total	671	2 149	12 307	15 127
L i a b i l i t i e s				
Short-term loans	212	723	2 693	3 628
Long-term loans	151	384	3 030	3 565
Taxable part of asset adjustment	88	313	2 438	2 839
Total debt	451	1 420	8 161	10 032
Share capital	68	149	1 271	1 488
Equity part of asset adjustment	63	226	1 766	2 055
Other equity capital	89	354	1 109	1 552
Total equity	220	729	4 146	5 095
Total	671	2 149	12 307	15 127
Debt/equity	2.05	1.95	1.97	1.97
Equity/share capital	3.24	4.89	3.26	3.42

According to table 2 the total of these inventory and depreciation reserves amounted to as much as 4 894 million marks at the end of 1962, or almost half the official balance sheet total. Thus the official balance sheets seem to give a rather distorted picture of the assets and financial structure of industry. This does not affect the debt-equity-ratio for the simple reason that at current tax rates the reserves are almost equally divided between debt and equity, which makes the ratio in the adjusted balance sheet only slightly lower (1.97). On the other hand, the composition of these two groups of liabilities changes considerably. It appears that shares play an even smaller part in equity capital than is indicated by official figures. For total industry the ratio of total equity to share capital is 3.42, for the middle group it is as high as 4.89. The equity part of asset adjustment alone exceeds the formal share capital and represents about 40 per cent of total equity capital. The taxable part of asset adjustment again is 80 per cent of long-term loans and 28 per cent of total debt.

The examination of year-to-year changes sheds further light on the picture.

Table 3 gives the annual changes in liabilities of industry during 1959-1962, adjusted in the same way as table 2.

Table 3. Annual increase in the liabilities of industry in 1959-1962 according to adjusted balance sheets

Million marks

	1959	1960	1961	1962	Total
Short-term loans	220	532	168	320	1 240
Long-term loans	308	536	491	508	1 843
of which: bonds	..	..	46	-18	..
loans from pension institutions	..	..	35	16	..
foreign loans	..	..	34	102	..
Taxable part of asset adjustment	296	385	350	392	1 423
Total debt	824	1 453	1 009	1 220	4 506
Share capital	110	90	91	85	376
Equity part of asset adjustment	215	278	254	283	1 030
Other equity capital	79	131	214	9	433
Total equity	404	499	559	377	1 839
Total	1 228	1 952	1 568	1 597	6 345

Our conclusions are further confirmed when we see that during the four years considered the increase in debt was almost 2.5 times that in equity capital. Even if the ratio were calculated on deflated figures, the picture would remain practically the same. Of the increase in debts the taxable part of reserves accounts for almost one third. Of the increase in equity the share of inventory and depreciation reserves represent more than half, and the formal share capital only 20 per cent. As for the increase in total liabilities, reserves have contributed 40 per cent, but share capital only 6 per cent, of which a considerable part consists of bonus issues.

As a further illustration some data for the longer period, 1947-1960, covered by MATTSON´s study may be added. From 1956, when the extra depreciation allowances were introduced, total depreciation reserves grew substantially and, at their highest level, corresponded to three-quarters of the simultaneous gross investments of firms.[1] Thus, from that time the increase in share capital was of little significance, and in fact the greater part of it took the form of bonus issues. Of the total increase in share capital during 1947-1960 as much as 56 per cent was bonus issues and thus less than half public (paid up) issues, and of the latter more than half were issued by government-controlled companies, which means that privately owned companies raised very little capital by means of public share issues.[2]

Conclusions and policy outlines

As will be clear from the foregoing the financial structure of firms depends, in the final analysis, on the availability and relative advantage of different forms of finance. Those responsible for taxation generally have wide opportunities to influence the terms of credit and thereby the decisions of firms. In Finland they seem to have made borrowed capital much more advantageous than equity capital, at the same time they have encouraged self-generation of funds at the expense of share issues.

Although under the present system it is difficult to stipulate to industry the exact form of its financial structure, it is undeniable that the current situation is not satisfactory. Both interest and redemption are regularly recurring costs which must be covered mainly by current income from sales. To a heavily indebted firm this is a considerable burden which requires that its activity remains high. Such a firm is obviously not in a position to sustain a drop in sales however temporary, still less to adjust itself to structural shifts required by more permanent changes in the market situation. Thus, the sounder the financial structure of industry, the better is it able to withstand fluctuations and adapt its production to such changes as trade liberalization and lowered customs duties have demanded and will continue to demand.

By international standards, too, the financial structure of Finnish industry is very unsound. When making investments involving considerable risk in developing countries, some international finance institutions demand that the equity of the firm concerned

1. MATTSON pp. 46-51.
2. MATTSON pp. 39-42.

should exceed its debts. In industrialized countries also it is generally held that equity capital should approximately equal the amount of borrowed capital, dependent on the nature of the firm's activity. Finnish industry is very far from complying with this standard, even if the equity part of estimated reserves is included.

One feels inclined to question whether the Government's economic policy is or is not intended to lead development in any specific direction. If the Government wants to be neutral, then it should obviously give the same tax treatment to all forms of finance open to industry. If it wants to influence the development of the capital markets and the financial structure of firms, its taxation policy should be rationally designed with this end in view, and should be such that it does not obstruct the attainment of other aims of economic policy.

In consideration of the aims of growth policy, measures to develop the financial markets and remove the anomalies in the present system are long overdue. The reforms should follow two main lines. Firstly, all forms of borrowed capital should be given equal treatment in taxation in order that such considerations should not govern the decisions of firms. Secondly, the mobility of funds should be increased and their channelling to the most productive forms of investment be encouraged. This will require thorough revision of corporate taxation.

The stamp duty is the first factor deserving attention. This is very heavy on share issues in particular, especially bonus issues. In another article the authors have suggested that the stamp duty on financial transactions should at least be made uniform, preferably abolished.[1] This suggestion has recently gained weight following an EEC report concerning uniformity of taxation of financial transactions in member countries. Although the stamp duties on share and bond issues are generally small in member countries, the report recommends that the charge on both foreign and domestic issues should be abolished, and that member countries should rapidly take measures to this end. Such re-

---

1. VALVANNE-LASSILA Stamp Duties ...

commentations will surely speed consideration of the stamp duties in Finland too.

Financing by equity

The most important reform that could be effected would be that which secured equal tax treatment of equity and loans. More developed countries than Finland have paid considerable attention to this question in recent years. In Sweden and Norway, for instance, dividends have been made partly or wholly comparable with interest in respect of taxation; both are deductible items whatever the form of capital. In Sweden dividends up to 4 per cent, paid on shares issued from 1961 to 1970, are deductible for six successive years in the period 1963 to 1977. In Norway, again, dividends paid on shares issued from March 3, 1961 to December 31, 1967 are deductible in full for eight successive years including the year of issue, with the proviso that the number of subscribers is more than twenty. In some countries dividends are normally deductible in full just as interest, without time limitations.

It has been suggested on various occasions that Finland should follow the example of Western Germany and some other countries, where distributed and undistributed profits are taxed differently. In Western Germany the rate is 51 per cent for retained profits and 15 per cent for dividends. As the tax paid on the latter is regarded as undistributed income, in reality 23.5 per cent tax is paid on dividends. A Government proposal regarding corporate tax on 1965 income is now being discussed by the Finnish Parliament. Two tax rates have been suggested: 42 per cent on that part of profits which is paid out as dividends and 48 per cent on retained profits.[1] This must be regarded as a move in the right direction, although the reform will probably be of little consequence. The statistics quoted earlier in this article indicate that financing by equity is really insignificant in Finland, a situation which is, without

1. The bill was passed by Parliament on November 20, 1964.

doubt, attributable to taxation in the first place. But it is equally clear that a difference of only 6 percentage units in the tax rates for dividends and retained profits cannot be a very strong incentive to paying dividends; local government and church taxes included, 55 per cent of the amount distributed would still be paid in tax.

In the opinion of the writers a far more radical change is called for, considering the need for additional capital to finance the economic growth planned. All possible tax relief should be afforded to dividends paid on new shares, as this would essentially promote financing by equity and encourage companies to raise their share capitals to values corresponding to the present price level. But relief should also be granted to existing shares, since it is particularly desirable that capital should be directed from old firms, which have already reached maturity, to new developing ones. For this reason the Norwegian provision stipulating a minimum number of subscribers should not be adopted in Finland because it is equally important that funds are released from family businesses. On the other hand it might be better to introduce these reforms for a limited period of time and then, on the basis of the experience gained, decide whether they should be made permanent. Firms could, for example, be allowed to deduct all dividends paid in all taxation during the next ten years, in addition to which dividends paid on issues made during the course of those ten years could be made deductible for the following five years also.

It seems likely that a reform of this nature would increase distribution of profits and willingness to increase share capital. The abolition of stamp duties would further the same ends, as would the changes suggested later (p. 16-20) concerning depreciation and undervaluation of assets. If all these revisions were carried out, firms would be far more interested in raising equity capital either by bonus issues, which would mean a reduction of their reserve funds or of depreciation and undervaluation reserves, or by paid up issues, which would bring about a real rise in their equity/debt ratios. This would widen the base for profits distribution and increase their readiness to pay higher dividends.

The inclusion of dividens in the costs of a firm would mean that less corporate tax revenue would accrue to the Government; instead, shareholders would pay more tax on their increased dividend receipts, the more so as the tax rate is progressive. Moreover, the right of shareholders to deduct 15 per cent of dividend income in State taxation could be withdrawn since it would no longer be needed as an incentive to buying shares.

Financing by loans

To promote credit financing it is essential that different kinds of credit are treated in the same way. An important step in this direction would be the abolition of stamp duties on transactions in bonds, bills and other securities.[1] In income taxation uniformity already exists in respect of the cost of loans, with the exception that interest paid on mortgage loans is deductible only up to a given maximum in local government and church taxation.

In this connection it may be stated that tax revision is not the only way of promoting external financing. Other forms of credit should also be developed to supplement bonds and bank loans, which are at present those most generally used. E.g. debentures are common in many countries, and have begun to be used in Finland, too. Other assets combining in various degrees such properties as security, mortgage qualifications, sharing of risk and return could be introduced. Another possibility would be to increase the liquidity of financial assets thus making them more attractive to investors. In many countries loan participation certificates are widely used. Such papers might interest banks, insurance companies and other institutions - perhaps transactions in them could even be made between the Bank of Finland and other banks.

The differentiation of interest rates and the use of index clauses should be extended to further the same ends. In the writers' opinion the rate of interest should be the lower the

---

1. VALVANNE - LASSILA Stamp Duties ...

shorter the period of a loan, and long-term loans should more generally be provided with index clauses. A firm should be able to obtain a short-term or occasional loan at a lower rate than a long-term mortgage loan. Index clauses again would secure the availability of long-term finance even during periods of inflation without placing a real burden on the firm since the nominal value of the firm's assets would rise with the price level. These aspects have been considered in detail in another article.[1]

Depreciation allowances and inventory valuation: averaging profits and losses

In order to increase the mobility of capital and at the same time promote its direction to the most important projects, the free undervaluing of inventories and depreciation allowances exceeding technical and economic life must obviously be abandoned. This presupposes, however, that the attitude of the tax-collector to the taxing of distributed profits changes in the way explained above, and that likewise the present "principle of the inviolability of the tax year" be given up, by allowing firms to average their results over a number of years.

Let us first examine d e p r e c i a t i o n a l l o w a n c e s. Since 1956 additional depreciation in State taxation has been granted for buildings, machinery and equipment obtained during that and subsequent years. The depreciation method has been degressive and annual allowances have been considerably greater than for fixed assets obtained before 1956. It has thus been possible for the investor to concentrate writing-off, particularly as regards machinery and equipment, in the first few years after purchase. The result of this has been that between 1958 and 1962 enterprises were, thanks to these additional value deductions, able to add to their reserves, as shown in table 3, some 2 453 million marks. As the share of potential tax in these reserves is 1 423 million on a 58 per cent tax

1. VALVANNE - LASSILA The Need for Reform ...

rate, it has of course been more advantageous, from the point of view of their results, for businesses to leave these reserves untouched, which is only possible by making new investments. We can indeed say that just as the former sales tax resulted in "sales-tax-orientated firms", the present depreciation stipulations have caused a desire for investment which has produced purely "tax-orientated investments".

As the writers see it, the depreciation allowances should immediately revert to the amounts corresponding to the technical and economic life of fixed assets, e.g. to the depreciation allowances still applicable to assets obtained before 1956. However, whether those percentage figures are still valid nowadays should be checked. This kind of reform is essential if we are to free ourselves from the misdirection of investment caused by taxation, and ensure that firms invest on a normal criterion of economic profitability. The depreciation method in taxation could simultaneously be simplified by preserving for machinery and equipment the same degressive value deduction allowance based on remaining value which is applied to present-day additional depreciation. This would correspond to the recommendations of the Tax Law Committee and to the example of Sweden and Denmark. The value deductions on machinery and equipment would then be carried out by applying a uniform percentage figure for the total joint book value of these assets. The depreciation percentage ought to correspond on the average to the depreciation allowances applicable to assets obtained before 1956.

Considerations of appropriate trade cycle policy also support the abandonment of value deductions exceeding technical and economic life. The Investment Fund Act indeed allows for the partial deduction of fixed assets even before they are purchased. Its aim is thus to time investment operations in such a way that reserves in the form of depreciation should be made during a period of rise or boom, so that such reserves could be used for investment during a recession. The larger the depreciation normally allowed, the less the stimulus offered by the investment fund method to such timing of investments. Increasing the efficiency of the investment fund method seems to require, therefore, the abandonment of excessive allowances. Clearly this was already intended when the present revised Investment Fund Act was drawn up.

This does not mean that value deductions larger than stipulated should be forbidden at all times and in all circumstances. They do act as a considerable incentive to investment, and are therefore, in certain conditions, an effective tool with which the government can direct the allocation of productive resources. In Finnish conditions taxation is a powerful weapon of economic policy which, if wisely used, can effectively promote economic growth. For this reason value deductions greater than permitted by the regulations should be granted only after careful consideration and to a limited extent, since if they become general and continue from year to year their effectiveness in channelling the investments of enterprises will be reduced.

As regards the regulations on i n v e n t o r y v a l u a t i o n, the Tax Law Committee recommends, pointing to Swedish examples, that a limit should be set on the undervaluation of inventories, up to which the values should be raised by degrees over a prescribed period. According to the detailed proposal of the Committee, an inventory must be evaluated at a minimum of 30 per cent of its replacement cost for industrial firms and at least 50 per cent for other firms, and this would have to be accomplished within ten years.

It seems to the writers that a reform along these lines would be quite inadequate. It cannot be considered an effective reform when it takes ten years to complete and even on completion still permits undervaluation of the same magnitude as is practised in numerous enterprises today, as was shown above (page 8). It is quite clear that if reform is not taken further, considerations of taxation will still dictate firms' decisions both as to the size and the timing of the acquisition of inventories.

A complete ban on unwarranted undervaluation seems therefore to be in order. Undervaluation should be allowed only to an extent corresponding to normal losses caused by expected fall in prices, when goods made "un-marketable" by changes in technical methods, in fashion, and other similar factors are taken into consideration. This kind of reform would mean of course that the present reserves resulting from undervaluation would become liable to tax. If the taxation regulations were not changed in other ways, the writing-off of these hidden reserves would have to be done over a considerable period, if the economic position of firms were not to become untenable. But there is also another, surprisingly simple solution, which has been successfully applied in Austria. Free undervaluation of inventories could be stopped completely from a given date, if at the same time firms were allowed to enter untaxed this increase in the value of inventories as part of their own capital, either by increasing their reserve funds or by raising their share capital with a bonus issue not subject to stamp duty. This would, on the part of authorities, be a recognition of the fact that the firms' inventory reserves would in any case be beyond their power so long as the inventories remain unchanged, and that firms are able to increase the inventory reserves as they themselves expand. Such a reform could quickly be put into effect and would solve once and for all the problems discussed above, which arise from the present undervaluation of inventories.

It should be added that the abandonment of undervaluation of inventories would at the same time offer the Government the long-needed opportunity to influence, by taxation measures, the timing of inventory acquisition according to the demands of cyclical policy. Purchases of inventories could then be included among those objectives for which investment funds may be used. This would be an effective way of stimulating stockbuilding during a recession and of slowing it down during a period of expansion. The question was considered when the revised Investment Fund Act was drawn up, but the conclusion was then unavoidably reached that including inventory acquisitions in the Act would have hardly any practical significance because of the practice of undervaluing.

If the reforms recommended above were carried out, the firms' possibilities of averaging profits and losses would be reduced since they could no longer resort either to extra depreciation allowances or to undervaluation of inventories.

As it is not at all times and in all conditions possible to take advantage of the provisions of the Investment Fund Act, firms should be allowed to deduct one year's losses from their income of the next or even several following years and in this way average their taxable income over a longer period. This method is commonly used in other countries, including Finland's neighbours Sweden, Norway and Denmark. The Tax Law Committee has considered a similar averaging procedure here, but decided against it because of technical difficulties in tax assessment. It did, however, at the same time recommend that the method be applied to newly founded firms for the first three years of operation. This position, adopted by the Committee although against its own principles, endorses the impression that it is high time to get rid of the "principle of the inviolability of the tax year", which certainly makes no sense from the financial point of view, and in this respect follow the example set by other countries.

Pension insurance institutions

When considering ways of increasing the mobility of investment capital, we cannot help giving some attention to the activities of the TEL pension insurance scheme. Since the scheme includes provisions which allow the firms to obtain loans from the funds automatically, moreover at a rate of interest lower than the current rate, it promotes the confinement of investment to the participating firms and thus effectively prevents the mobility and direction of investment on a profitability basis to industries capable of expansion. It would obviously be sensible to develop the activities of the pension insurance institutions to the point where they would offer long-term consolidated financing to industry. They could invest their funds in firms' bonds, shares and debentures, and grant long-term credit to industry. This could be carried out in co-operation with other credit institutions. Let us recall the idea put forward earlier for the development of new forms of financing, when we referred to special loan participation certificates. By buying such certificates from financial and credit institutions specializing in industrial financing, the pension insurance institutions could also support the long-term financing of industrial investment.

Balance sheet analysis

An additional advantage which would ensue from these proposals concerning depreciation and inventory reserves would be the simplification of balance sheet analysis. Today, as is well known, suppliers of finance, whether banking institutions granting loans or private persons willing to buy shares, cannot make a reasonable assessment of a firm´s financial soundness on the basis of its published balance sheets. The proposed reform would greatly improve the situation in this respect. If all the various assets were entered at their real value, as is now the case for borrowed capital, investors would be able to form for themselves a tolerably correct picture of firms´ financial positions. This point alone would be sure to add to the interest in share investment and would fundamentally improve credit institutions´ chances of making risk evaluations, which for their part may well be of importance in directing funds into fields capable of expansion. Estimating risk on the basis of official balance sheets is particularly difficult, especially for foreign investors. It is a well-known fact that the difficulty of balance sheet review has hindered many firms in their efforts to get credit from abroad, particularly if it has turned out that businessmen themselves do not know the real financial positions of the firms they are managing because of distortions in the formal bookkeeping.

Tax Revenues

The regulations on the distribution of profits, depreciation allowances and the valuation of inventories naturally have an absolutely decisive effect on how a firm´s taxable income is determined. To illustrate this point, table 4 gives information about state income taxation of firms from 1952 to 1961 as revealed in official statistics - there are as yet no more up-to-date statistics available.

Table 4. State taxation of firms on their revenues for 1952-1961

	Tax rate %	All joint-stock companies: Taxable income	All joint-stock companies: Income tax	Industrial joint-stock companies: Taxable income	Industrial joint-stock companies: Income tax
		million marks			
1952	32	595	190	259	83
1953	32	559	178	245	78
1954	38	634	242	287	108
1955	38	729	275	325	123
1956	32	515	164	307	98
1957	38	490	183	286	108
1958	38	492	183	290	109
1959	45	561	244	345	153
1960	38	587	219	343	130
1961	38	655	245	371	140

The significance of the additional depreciation allowances granted at the beginning of 1956 has been emphasized in several connections. The table shows clearly that their effect on income taxation has been quite far-reaching. The taxed incomes of all joint-stock companies dropped from 1955 to 1956 by almost 30 per cent, and neither these nor the income tax itself ever regained its previous level during the period under review. The incomes for 1961 barely exceed the incomes for 1954. Development among industrial joint-stock companies has followed the same trend, though their taxable incomes for 1959-1961 do already exceed the 1955 level.[1]

Such a modest rise in taxable incomes is all the more remarkable when we bear in mind the considerable expansion which took place in production after 1955 and the fact that 1959-1961 was also a time of boom. According to the national income statistics, corporate profits, before deduction of direct taxes, rose by a full 36 per cent from 1955 to 1961. The development in firms´´ taxable incomes cannot, as we see it, be explained in any other way than that the additional depreciation allowances and partly, too, the undervaluation of inventories, have decisively reduced the tax base. In this connection, we cannot help noting the utter negligence which allowed these additional depreciation allowances to remain unchanged even during the years of expansion, which was, of course, in direct conflict with the counter-cyclical

1. The comparison with 1955 would be even sharper if the effects of inflation were eliminated, as from 1955 to 1961 the price level rose by 29 per cent according to the wholesale price index and by 41 per cent according to the cost of living index.

aims of these regulations.

Putting the reforms proposed in this article into practice would naturally change the methods by which firms´ taxable income is determined. The abandonment of additional depreciation allowances would bring about a substantial increase in taxable income. The abandonment of undervaluation of stock - supposing this were carried out in the Austrian way - would have the same effect at least in the long run, though the short-term result depends on possible fluctuations in stock. Averaging losses against gains would for its part not have any effect on state taxation on the average, over several years. On the municipal side, the result would depend i.a. on how local authorities would use their discretionary power in assessing taxable income in those cases where the law allows discretion on their part. The freeing of distributed profits from taxation would, on the other hand, correspondingly reduce taxable income. As regards wealth taxation it must be pointed out that the removal of depreciation and inventory reserves would add to the taxable wealth of businesses.

Since the reduction of depreciation rights would obviously add to taxable incomes considerably more than the freeing of distributed dividends would reduce them, one general result of these reforms would be a rise in the taxable income of firms. This extension of the tax base can be considered certain, even though firms´ distribution of profit following the reforms would rise considerably. This means that to collect the earlier amount of taxes the state can lower the income tax rate for firms correspondingly. Thus, the reduction of the income and wealth tax rates forms the final link in the chain of reform proposals outlined above; this could now be carried out without the state´s losing any tax revenues thereby.

Conclusions

A study of business taxation from the point of view of the development of financial markets gives a very disquieting picture of the present way in which public taxation policy is applied. It seems quite clear that in many different facets of fiscal policy "one hand doesn´t know what the other is doing" - the general economic objectives and the taxation policies pursued conflict violently with each other. We have already given the explanation for this, i.e. the taxation regulations have been formed over the years from a number of separate decisions and no one has stopped to weigh up their overall effect. We may well now wonder how this has been possible and how the Government´s economic policy has been pursued in a way allowing decisions on taxation to be made with such indifference to the generally approved overall aims.

The various kinds and levels of regulations, stipulations, directions, interpretations and court judgements concerning taxation make up the rules of a game which firms must follow in their efforts to improve their financial standing. This piecemeal set of regulations is what finally decides what it is profitable for a firm to do and what not. In business life the consequences of this are generally known and admitted. When a firm´s income tax is 58 per cent of its income, nothing can be a more worthwhile investment than one in which taxation is avoided completely or partly. One of the most important criteria in a firm´s operations, then, is the profitability of an investment from the taxation point of view, and not at all the economic significance of the investment e.g. to the overall development of industry. Any leading business man - or any tax official - can offer you a number of illustrations where it is more profitable for a firm to invest in projects well known to be against the long-term interests of industry. Some examples, such as investments outside the firm´s own field of operation solely to maintain depreciation rates, have already been cited above. It is likewise generally recognised that a firm wastes much effort and goes to much trouble to work out the ins and outs of taxation on which the profitability of the firm´s operations may well decisively depend.

One of the primary thoughts in the writers´ mind throughout the study made above was that as the rules of the taxation game do in fact have a decisive influence on a firm´s operations, these rules should, in all logic, be revised in order to serve the general interest. If the highest aim of public economic policy is to reach the economic growth target set for the next few years and decades in order to safeguard high employment, and if the achievement of this aim presupposes e.g. the development of new fields of industry, improvements in competitive ability, and development of the financial market, let us then change the rules of the game to correspond with these aims. When making investment decisions firms do and always will consider how taxation will affect their financial standing.

We have had good reason to emphasize firms´ attitudes to taxation and to the opportunities the latter offers for making money, since for some reason this question has been "untouchable" in public. The present taxation system is, however, tacitly understood to lead to senseless, even ridiculous consequences in many cases. At the same time there is a diffidence about making proposals for reform - perhaps because partial solutions could merely lead to other kinds of distortion. On the other hand, there is a considerable readiness in business circles for radical overall reforms, which are recognised as advantageous to the whole economy.

It has been the aim of the writers to outline this kind of complete reform, one which, if realised, could serve the objectives given above. The criticism made shows, in our opinion, that this kind of total reform must work on a very wide basis and apply to all the main principles of business taxation without prejudice, irrespective of how traditional and sacrosanct they are. Thus, it was essential to tackle the most important aspects of business operations, such as the undervaluation of inventories, depreciation allowances, financial structure, dividend policy, the availability and various alternatives of financing, income and wealth taxation and stamp duties. It is clear that this kind of reform would change quite decisively the conditions under which firms operate - but that, indeed, was our purpose.

We must here pay some attention to the fact that in various parts of Europe there have recently been lively discussions about the same kind of questions, and proposals for reform have been drawn up on the very same lines. In many instances above it was possible to provide examples of reforms carried out or suggested recently which lay stress on the rational taxing of business and the removal of tax obstacles to economic development. We, in Finland, have good reason to ensure that we do not lag behind the fast development in countries which are our competitors. Otherwise we can hardly expect that Finland will get sufficient amounts of the foreign capital and the technical and economic knowledge which are essential to our economic growth.

Our article is related to some earlier or contemporary articles dealing with the development needs of our financial markets and taxation from various angles.[1] This reflects our impression that reforms, to be really total reforms, must be extended to cover the entire taxation policy in a wide sense and also monetary and credit policy. If the rules of the taxation game are changed throughout, money and credit policy are to be - and they can be - rebuilt on new foundations.

This will mean e.g. that the reforms made in business taxation must be executed in such a way and at such a speed that they are in harmony with reforms made in other sectors. The purpose of the reform proposals made above has therefore been to indicate the direction that taxation development should take. Above all, the present situation needs to see the start of honest, unprejudiced discussion about these questions both by the Government and by business circles. Finally, unanimity should be reached on the main lines of the total reform, in such a way that these are in harmony with the simultaneous plans for real economic growth. If this is achieved we will have a sound basis for the partial solutions required for this reform.

---

1. The article on The Framework of the Bank of Finland's Monetary Policy by HEIKKI VALVANNE in Kansantaloudellinen Aikakauskirja No. 1, 1965 will be published in English in this series.