

Savings, investments and economic growth

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The primary importance of capital accumulation for economic growth is a well too known tenet of economic theory. Abundant empirical evidence corroborates the high correlation between the investment rate and income growth.

Investments both increase the production capacity of the economy (physical capital) and support technical innovation (higher factor productivity).

Savings are used to finance investments. The shortage of domestic savings is not considered to be a constraint to investments in an open economy - foreign savings presumably make up for the difference. A National Accounts identity sets the difference between gross savings and investments equal to the current account balance of the balance of payments (ex post). Hence, given a low rate of savings, investments can only expand if foreign indebtedness grows. Balance of payments deficits exert pressure on the exchange rate and fuel inflation.

(Sometimes economic development is viewed as the outcome of the interplay of two complementary scarce resources - foreign currency and capital. The foreign currency shortage limits growth since the attainment of higher GDP levels requires higher imports.)

Foreign imbalances can be avoided if economic policies are pursued that encourage the accumulation of savings and their transformation into investments. Such policies brought about remarkable economic prosperity in certain East-Asian countries.

Savings and investments in Bulgaria

Until 1990 the savings and investments levels (share in GDP) maintained in Bulgaria were comparable to those in the developed economies. High savings rates in the 80'ies however were due to shortages of consumer goods and services rather than to autonomous decisions of economic agents who have strong preferences for future consumption. When prices and imports were liberalised (1991) and real incomes fell, the share of savings in GDP declined.

During the period of central planning investments resources were allocated by force of administrative decisions; no consideration was given to the return on capital. Besides, the distorted prices did not allow for meaningful assessments of such market indicators.

Investments were drastically reduced after 1992. Macroeconomic instability, low demand and delayed privatization all contributed to the slump in investments. The shortage of financial resources was another important constraint.

It should be clear that reduced investments are not an inevitable outcome of economic transition. Unlike Bulgaria, the remaining countries from Central and Eastern Europe managed to maintain a relatively high ratio of investments to GDP.

To overcome the difficulties that currently plague the Bulgarian economy, policies should be pursued that encourage savings and investments. The tax reform features among the most important policy measures.

Impact of the tax legislation on savings and investments

The share of corporate savings in total savings has stood as high as 50% in the developed economies. In Bulgaria however, the only sector that generates non-negative savings has been the households sector; (the informal sector may be another net saver but no reliable information is available). The non-financial sector has been recording negative savings in recent years, which is partly due to

regulations that put at disadvantage state- and municipally-owned firms (the former Decree No.56).

Firms savings generally take the form of depreciation allowances which are not taxed, so the size and time structuring of savings strongly depend on the depreciation method adopted. With accelerated depreciation tax payments are postponed and savings accumulate rapidly in the first years of the asset's life.

Retained profits form the second component of firms savings. Retained profits depend both on tax rates and the firm's dividend policy. It is well known that higher tax rates have a strong negative impact on savings.

The incentives of the potential investors should be examined when assessing the tax policy impact on investment activity. We use here the theoretical framework provided by Musgrave, R. and Musgrave, P. (1989)

Three main factors affect the investor's behaviour, acting jointly or in their own: (1) expected net rate of return, (2) sales dynamics and its relation to existing production capacities (3) amount of internal resources, i.e. after-tax profits and accumulated depreciation allowances. Among the three variables profits are most important for the investment decision. The higher tax burden lowers profitability. Investments are reduced whereby the amount of the reduction depends on the elasticity of the investment function. (We consider here the effective tax rate, which includes both the nominal tax rate and the tax treatment of depreciation; both components are used to derive the rate of return.)

Each firms strives to achieve high enough profits to cover the market interest rate and depreciation, i.e. the price of capital. When taxes are imposed, net rates of return depend also on the amount of the tax rate, the tax-deductible depreciation and the investment credit (if applicable). The higher the investment credit and the tax deductible depreciation, the lower the required rate of return and the higher the probability of taking up the investment. Alternatively, high tax rates push up the required rate of return and discourage investors.

Besides, investments bear certain risks that are accounted for in the probability distribution of the expected return. This factor carries an additional importance in Bulgaria due to the high macroeconomic instability.

Tax treatment of investments in Bulgaria

The Decree No.56 regulations were applied prior to the adoption of the new Law on the profits tax (July 1996). These regulations provided for a highly unequal treatment of economic units, depending on their form of ownership.

Higher tax rates were applied to state- and municipally-owned firms, their depreciation allowances were not adjusted for inflation and only 75% of interest was tax-deducted.

Private firms in turn benefited from the existing legislation. They were offered a choice between a one-shot deduction of the full purchasing price of the asset and a deduction of the principal of a loan, used to finance the investment. The preferential treatment applied however only if the amount deducted did not exceed before-tax profits, which caused troubles to small, newly created firms with no recorded profits.

It can be inferred that the former legislation did not impose taxes on investments, financed by internal resources and even provided for subsidising private investments, financed by borrowed funds. At the same time investments in the state-owned firms were discouraged, which resulted in decapitalization.

The new Law marks a significant progress by introducing equal treatment of the different forms of ownership. Another positive development has been the reduction of the corporate profits tax rate to 36% (26% for profits below 2 mln. levs). However, investments receive a worsened treatment: the one-shot deduction at asset acquisition has been abolished; a depreciation period has been fixed instead, whereby depreciation allowances are not indexed to inflation. In a high inflation economy such an approach deprives firms from internal resources (savings) and thus eliminates one of the major sources of investment financing. The changing macroeconomic environment together with a repressive tax policy will further reduce

the rates of saving and investments. Unless the pending structural reform includes measures to encourage investments, the prospects for renewed economic growth may remain unclear.

Proposed legislative changes concerning depreciation

Provided that the principle that depreciation allowances are deducted during the asset's life is maintained, the law should be modified in several important respects.

First, adjustments for inflation should be introduced - high inflation makes it impossible to recover capital outlays if depreciation is based in the initial purchase price. High inflation poses the threat of decapitalization, hence the book value of the assets should be adjusted to reflect their current market price. Asset indexation requires revaluation of all balance-sheet items.

Second, the principle of "tax-neutrality" should be observed, i.e. taxes should not distort the structure of investments. A necessary prerequisite thereto is that the true economic depreciation equals the normative one - if so, the effective tax rate equals the nominal one.

Third, the annual depreciation rates provided for in the Law can be corrected according to the principle of the "best business practice" which ensures neutrality. If the principle is adopted, certain assets may depreciate at a faster rate, e.g. computers (20% depreciation rate according to the Law). A more flexible approach can be undertaken and taxpayers may be given some freedom to vary the asset's life within certain limits. The reduced normative life of the asset will encourage investments.

Fourth, the depreciation method can be reconsidered. Only straight-line depreciation is currently applied. It may be kept for buildings, whereas the method of decreasing book value can be applied for machinery and equipment (under the latter method the present value of depreciation allowances is higher). Accelerated depreciation is usually thought to benefit investors, since the tax rate is reduced as tax payments are postponed. This is mostly true for long-term investments. (The theory of investment decisions again supports such a statement. To assess an investment one needs to compare the present value of the (before-tax) income flow to the present value of taxes due. Obviously, the faster the depreciation, the lower the present value of taxes.)

Some countries apply an "investment tax credit". It is intended to encourage investors by tax-deducting some fixed percentage of the value of the investment. This credit resembles the accelerated depreciation but for one key difference: the latter postpones the tax payment whereas the former directly reduces it. The term of the investment should also be taken into account, since the investment credit benefits shorter-term investments. The joint application of accelerated depreciation and investment credits can be successful as well.

Given the current economic crisis in Bulgaria, a more radical approach has been proposed by Zodrow (1995) - "capital recovery during the first year". The proposal essentially states that the sum of the present values of all future depreciation allowances should be deducted in the first year after the asset acquisition. The discount rate used should be applied for adjusting the value of losses brought forward to future reporting periods as well. The advantage of this method (which is a version of the accelerated depreciation) is seen in the elimination of the adverse impact of inflation and the increase in the firm's free resources. Savings however can only be accumulated if income is generated from other investments.

When tax policy is devised all advantages and drawbacks of the above approaches should be assessed. A reduction of the tax rate to 20-25% is also desirable. Besides, budget revenues may not suffer from such a reduction, since part of the "informal economy" may enter the formal sector, which is particularly plausible if the tax legislation reform is paralleled by an improvement in the tax administration. The proper assessment of the fiscal effect naturally requires an in-depth analysis which cannot be undertaken in the present paper.