Canadian
Pulp and Paper
Association
2300 Sun Life Building, Montreal, Que., Canada H3B 2X9

222-94

SUBMISSION

ON

INVESTMENT INCENTIVES

JANUARY 1978

INVESTMENT INCENTIVES

1. Introduction

We have followed the studies of the pulp and paper industry which the federal government, and several of the provincial governments, have undertaken during the past two years. These should create a better understanding of the industry and the economic environment in which it exists. They should also provide a sound base from which to develop the new policy initiatives that are needed so urgently.

This submission is concerned with such initiatives. It discusses government financial incentives for investment, and suggests guidelines that the member companies of this Association believe should be followed in the selection of appropriate policies for the pulp and paper sector. It also recommends a specific approach: a forest products industry investment allowance, available to all companies and applied through the tax system.

Such an approach could make an extremely important contribution to the rebuilding of Canada's competitive ability in pulp and paper manufacture. Moreover, it would go beyond the traditional concept of grants, which in this industry have been perceived as discriminatory, and insensitive to market conditions, giving an unfair advantage to some companies at the expense of others.

The fact that the grant technique has been used quite widely does not mean that it is the best way to stimulate investment, or strengthen a sector of the economy or a region of the country. In fact, a number of our member companies which have received grants have argued for some years that so far as pulp and paper manufacture is concerned, there are better ways.

2. Guidelines

We should like, therefore, to suggest guidelines or principles which we believe should be applied in the development of any new programs of investment incentives for this industry. Their basic thrust was expressed by this Association in a letter of June 1973, to the Minister of Regional Economic Expansion:

1. The industry would prefer general economic incentives, such as tax incentives, to grants for specific installations, so that all producers and thereby the industry as a whole would be strengthened.

2. The incentives should be employed in a manner that is non-discriminatory amongst companies.

3. They should cover a wide range of situations, in both mills and woodlands, not only expansion but also modernization and productivity improvement, pollution abatement, energy conservation, and forest development and improvement.

4. The benefits should be earned; for example, they could be in the form of a reduction in taxes for enterprises reporting taxable profits and which have made qualifying investments.

Acceptance of such guidelines would in our view make for an incentives program which is effective, equitable, and easy to administer, causes the least possible distortion of normal market forces, and yet is in harmony with federal and provincial goals in economic development.

It would also recognize a fact which is increasingly apparent from the current world supply/demand imbalance in many pulp and paper products, and the world market outlook through to the early 1980's. This is, that the

Canadian companies in the next few years will be pre-occupied with making their present manufacturing facilities and forest operations more efficient and more productive, and thus more cost-competitive in world terms. They will be less concerned with programs of major expansion than in some earlier periods of their history.

That is not to say that for Canada the era of dramatic pulp and paper growth is necessarily over. It does mean that the more immediate priority for most companies will be to improve the financial performance of existing mills. This will restore the strong base from which the Canadian industry can then move on to participate in serving the substantial increases in world demand for pulp, paper and paperboard yet to come; increases that will ultimately require large spending to increase productive capacity somewhere in the world.

In these circumstances capital investment in literally hundreds of diverse projects, large and small, is essential to the rebuilding of the Canadian industry's competitive strength. A more adequate program of investment incentives, applicable to companies on similar terms, could be an important part of that process. It would not solve all of the problems. But it is one of many measures which could make a very substantial contribution.

3. Investment Allowance

In applying their programs of economic development, federal and provincial governments in Canada, and governments in other western countries, have chosen from a wide range of instruments: grants, capital cost allowances, low-interest or interest-free loans, loan guarantees, tax-exempt bonds, investment tax credits, tax holidays, transportation subsidies, the building of roads and other infra-structure, and manpower training and relocation schemes. Some of these measures are more applicable than others to the problems of today.

The guidelines we have proposed would best be satisfied, in our view, by a forest products industry investment allowance, available to all companies and applied through the tax system. This would go beyond the traditional concept of grants, and have many advantages. Besides being effective, it would be fair, simple and easy to administer; and give maximum opportunity for market forces to determine the order in which investment needs are met. It would have to be earned, and there is great virtue in that. Finally, it would involve no outlay of government funds, but rather, a one-time reduction in tax revenue, for investments expected to show a continuing, taxable profit.

This particular approach is one which our industry put forward in 1971, in a CPPA submission calling attention to the serious corporate tax disadvantages under which the industry was operating, particularly in relation to competitors in the U.S. We make no apology for reintroducing it, in part because it offers so many advantages over other incentives, especially grants; and in part because the problems of financing capital expenditures are at least as difficult today as they were at that time.

As shown in Appendix I, earnings have generally been low, and inflation has placed a severe drain on funds available for investment, as companies struggle to maintain a reasonable level of liquidity. Even when book profits show significant increases, as some have recently, the amount of cash actually available for spending on capital projects is far short of requirements.

Still true.

When profits are declining, as in the market pulp sector at present, then the situation is more serious still.

Our proposal for an investment allowance is designed to improve financial returns, and generate and attract capital. It would provide that for companies in the forest products industry, for each two dollars spent on investments in qualifying projects there would be an allowance of one dollar. Companies would be permitted to deduct these allowances from income, and the maximum allowance in any one year would be one-third of income in that year. Unused allowances would be available for carry-forward.

We would be glad to discuss the specifications for qualifying expenditures. In our view, they should be broad, and include the following:

a) Expenditures designed to improve a company's productivity and competitive position, such as for modernization, cost reduction, energy conservation, plant improvement and machine replacement.

b) Expenditures designed to improve forest growth and the efficiency of woodlands operations, such as the installation of roads, camps and other facilities and the development and purchase of woodlands machinery and equipment.

c) Expenditures to take advantage of new and expanding markets, such as new mills, expansion of existing mills and introduction of new products in existing plants.

d) Expenditures for pollution abatement.

We acknowledge that the federal government now provides an investment tax credit, which in the 1977 budget was increased for some regions. But this still falls well short of what is required.

We submit that there is a strong case for a forest products industry allowance along the lines we have suggested, in addition to the existing investment tax credit provisions.

To ensure that the full benefit is available to augment the cash flow of the taxpayer, as is done with respect to investment incentives in the United States, we recommend that section 13(7.1) of the Income Tax Act be amended to exclude this particular allowance from the provisions of that section. Failure to do so would result in the elimination of a large portion of the benefit within the same and the following year, through the operation of reduced capital cost allowances in the pollution and production machinery classes.

We urge that both federal and provincial governments make arrangements in their taxation legislation and regulations to implement fully the proposed incentives program.

The program should ultimately generate tax revenues in excess of its costs, and contribute to the achievement of major government objectives such as higher rates of growth, a better long-range export performance, improvement in the balance of payments, and higher levels of employment. It would have very considerable impact on the pulp and paper industry. By improving the ability of companies to invest, it would strengthen the international competitive position of this sector which is so important to economic activity and employment in each of the regions of Canada, and to the Canadian economy as a whole.

We urge that it receive serious consideration and would appreciate the opportunity to discuss it in greater detail.

APPENDIX I

The tables in this appendix illustrate one of the difficult financial problems of Canadian pulp and paper companies in recent years. The problem, a cash squeeze, has been caused not only by low earnings but also by high rates of inflation, which bear with particular severity on capital-intensive industries.

The high rates of inflation have obliged companies to increase their working capital sharply, diverting funds which would otherwise be available for long-term investment in plant and machinery. This, combined with the steadily rising cost of capital equipment, has made it more difficult to undertake projects to modernize, increase productivity, fulfill environmental requirements, and indeed, even to replace fixed assets and thus maintain the basic productive facilities.

Obviously, there are many measures which the industry must undertake to improve its profitability. But governments also have a role and a responsibility. By increasing the amount of cash left in the business, a more adequate program of incentives for investment such as we have suggested could ease this financial problem substantially. It would help to make possible those capital expenditures which are so necessary if the cost-competitiveness of the industry is to be improved.

1. The extent of the cash squeeze is shown in Table 1, compiled from Statistics Canada data for the paper and allied industries, and forestry.

Table 1

PAPER ALLIED & FORESTRY
STATEMENT OF SOURCE AND USE OF FUNDS

	$ MILLIONS					
SOURCE OF FUNDS	1972	1973	1974	1975	1976	1972-76
Net Profit	56	249	689	337	286	1,617
Deferred Taxes	1	57	162	112	98	430
Depreciation, Depletion, Amortization	288	301	327	346	372	1,634
Total	345	607	1,178	795	756	3,681
USE OF FUNDS						
Plant and Equipment	406	171	586	577	592	2,332
Other Investment	130	50	190	(56)	4	318
*Increase (Decrease) in Working Capital	(103)	84	361	244	277	863
Dividends	65	139	248	163	197	812
	498	444	1,385	928	1,070	4,325
Balance	(153)	163	(207)	(133)	(314)	(644)

*(Excluding short term debt)

FINANCED BY:	
Increase Long Term Debt	311
Increase Short Term Debt	279
Increase - Other (Net)	54
	644

The table shows internally-generated funds, and the use made of those funds plus capital raised from outside sources. For the five-year period, $863 million or 23% of the $3.7 billion cash flow was used to increase working capital. This was to maintain corporate liquidity in a period of rapid inflation. But it cut deeply into the funds available for reinvestment in plant and equipment.

This particular five-year period was one of only moderate expansion in the pulp and paper industry's productive capacity. Yet there was a gap of $644 million between funds generated internally and requirements, bridged largely by increasing long and short-term debt by $590 million. Obviously, borrowing on such a scale to finance current operations cannot continue indefinitely. Debt - equity ratios can become too high, and then companies have no choice but to contract their level of capital expenditures.

What is needed is the retention of more capital in the business. An investment allowance, as proposed in this submission, would help to meet that need.

2. Another way of looking at both the cash problem and the problem of maintaining an adequate level of investment in plant and equipment is to calculate reported earnings on the basis of inflation accounting. Table 2 was prepared for CPPA by Touche Ross & Co. It shows the earnings reported for 1975 and 1976 by a sample of ten Canadian forest product companies, using conventional accounting methods. It then shows these results recalculated by the current value method, which is similar to that recommended recently by the Ontario Committee on Inflation Accounting.

Table 2

RECONCILIATION OF HISTORIC NET EARNINGS
TO CURRENT VALUE LOSS FOR 1975 AND 1976

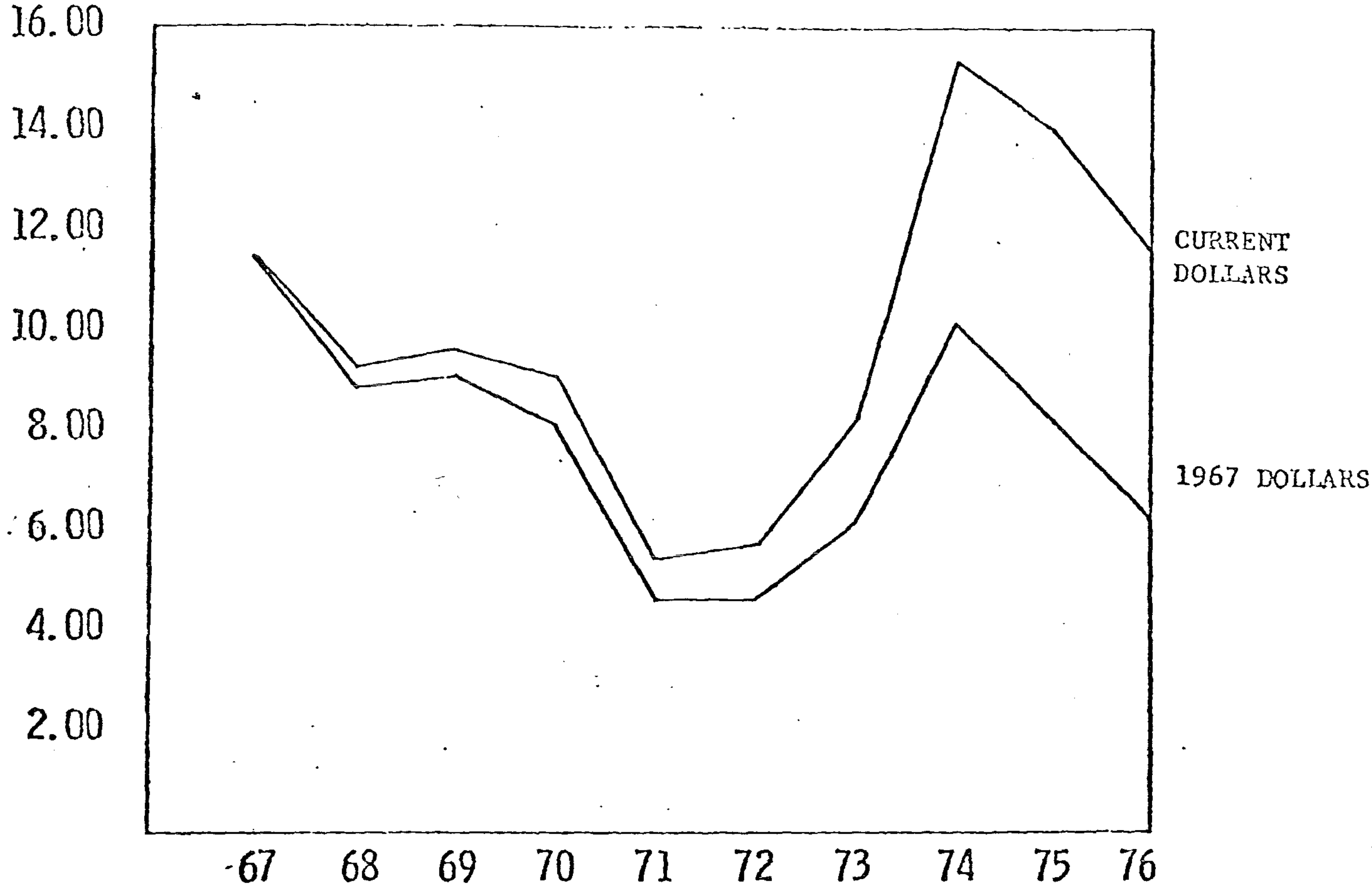
	--------MILLIONS---------		
	1975	1976	TOTAL
Historic Earnings	$ 91	$ 138	$ 229
Adjustments:			
Additional Replacement Cost Depreciation	(260)	(283)	(543)
Replacement Costs for Goods Sold	(85)	(61)	(146)
Reduced Income Taxes	55	30	85
	(290)	(314)	(604)
Current Value Loss	$(199)	$(176)	$(375)

It can be seen that what seemed to be a $229 million profit for the two years was in reality a $375 million loss. And the largest element in that drastically changed picture was the additional depreciation which would have to be charged in order to provide for the replacement today of fixed assets purchased at a time of much lower costs.

This means that the investment requirements of the industry, merely to maintain itself, are far higher than is suggested by the financial statements prepared in the traditional way. It underlines, again, the urgency of adopting remedial measures which will assist in providing the funds necessary to satisfy those requirements.

3. Lest it be thought that shareholders have drained away needed cash from the operations of the industry, we have included the following graph, showing dividends paid per common share by 13 public Canadian forest products companies in the years 1967-1976.

DIVIDENDS PAID PER COMMON SHARE
BY 13 PUBLIC CANADIAN FOREST PRODUCTS COMPANIES
1967-1976



SOURCE: Company Annual Reports

The chart shows that in current dollars the dividends per share have increased from $11.51 to $11.70. In constant dollars, they have dropped to $6.32. Moreover, as shown in the following Table 3, dividends have been paid out of a very small return on capital investment.

Table 3

18 CANADIAN FOREST PRODUCTS COMPANIES WHICH REPORT PUBLICLY:

	1970	1971	1972	1973	1974	1975	1976
Net earnings after taxes (millions)	$58.9	32.8	93.8	285.8	457.4	171.2	172.1
Net assets or capital employed at year-end (billions)	$ 3.4	3.4	3.3	3.7	4.2	4.8	5.2
Return on net assets after taxes*	2.8%	2.1%	3.8%	8.8%	11.8%	4.7%	4.7%
Weighted average return on net assets after taxes 1970-76	------------------ 5.7% ------------------						

* Calculated on the basis of operating net earnings plus interest, after tax.