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Tax and Investment: Through the Growth Lens

On-going Reforms and Challenges

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Foreign Investment Advisory Service (FIAS)

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- **FIAS advises governments of developing and transition countries on how to improve their investment climate for domestic and foreign investors.**
- **FIAS is a multi-donor service of the International Finance Corporation (IFC) and the World Bank, and focuses on four core areas:**
 - investment climate diagnostics
 - investment laws and promotion
 - administrative barriers solutions
 - industry competitiveness
- **More recently FIAS has conducted studies in 10 countries in Sub-Saharan Africa and MENA on the impact of the Tax systems on the Investment Climate**

- 1. Tax as an Investment Climate Issue**
- 2. Metrics**
- 3. What is a good tax environment?**
- 4. Special issues: GST/VAT & SMEs**
- 5. Next Steps – More Diagnostics, Research & Implementation**
- 6. Responses: Q&A**

1. Tax as an Investment Climate Issue

Traditional Revenue Goal

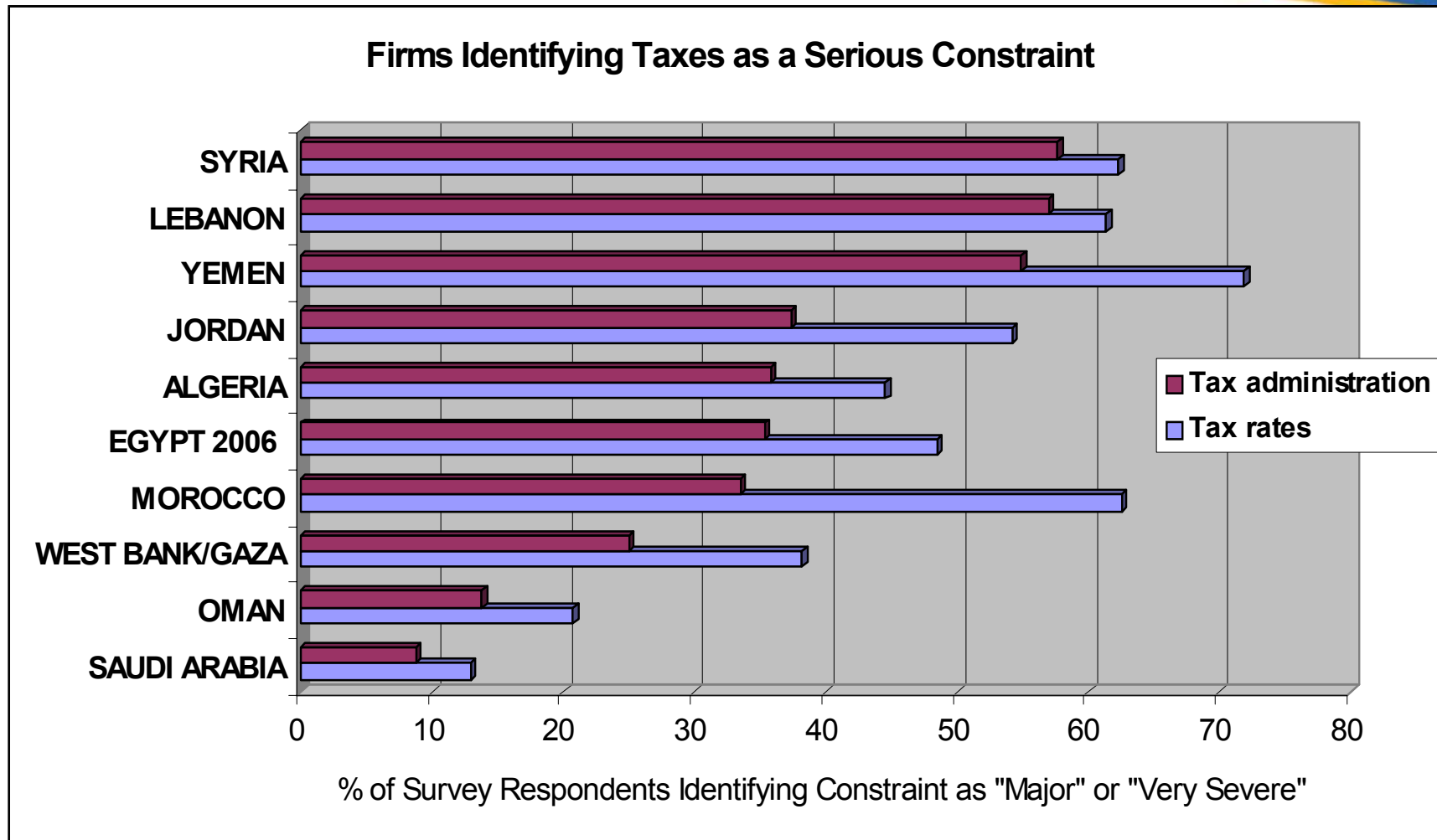
- Raise Revenue for government expenditure
- Hence for the Government: Financial viability of taxation important

Development/Growth Goals

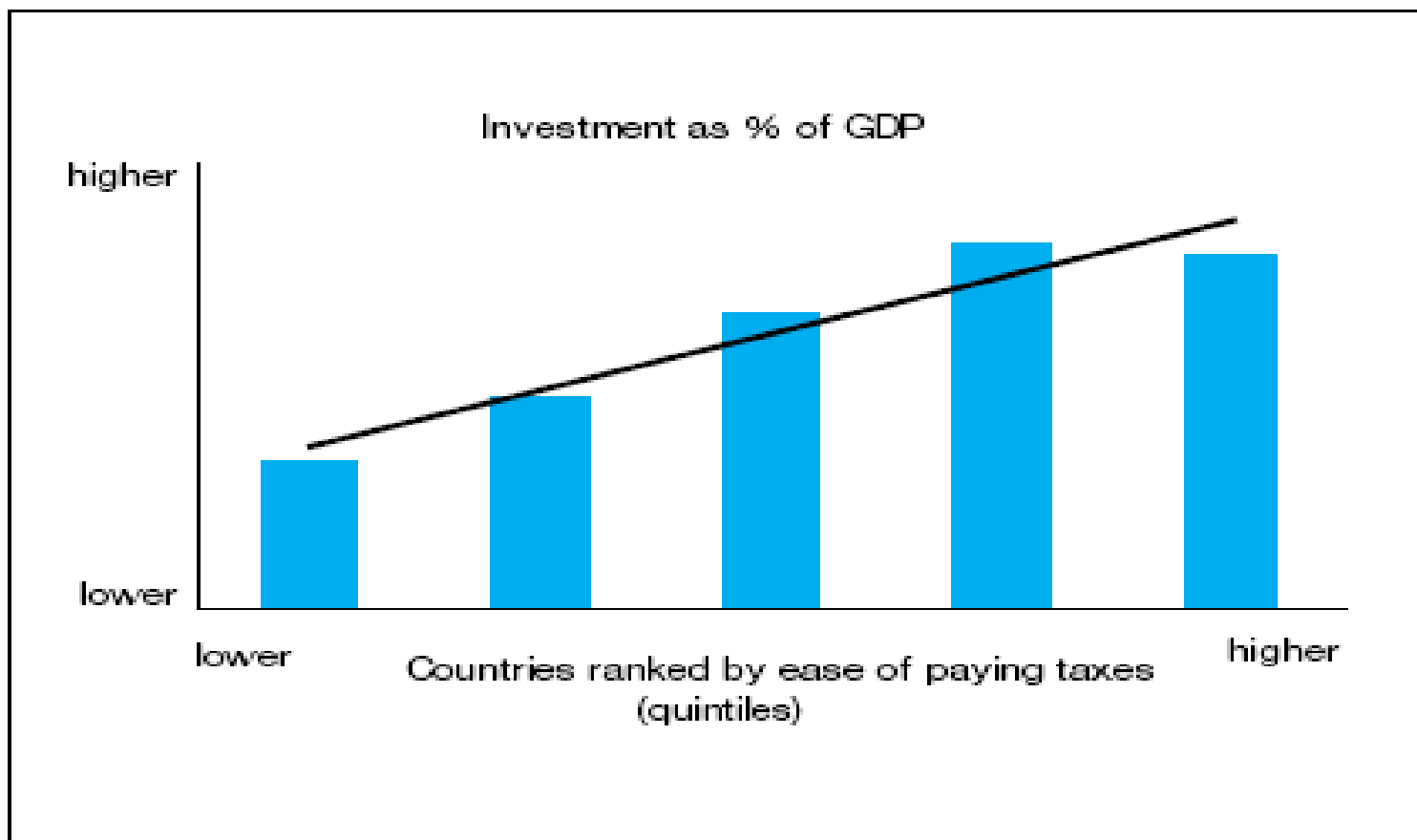
- Create a “culture of taxation” regularization of the rule of law (Social Cost-Benefit rather than Financial)
- To increase the size of the formal sector
- To promote growth

- Tax policy and tax administration matters for both domestic and foreign investors
- Tax affects international competitiveness
- A stable, transparent, even-handed tax regime is perceived by investors as a sign of established rule of law
- Tax regime is a pillar of the legislative and regulatory system
- Tax compliance facilitates economic activity

Tax is a Major Factor for Firms



Burdensome taxes leads to less Investment



Source: Doing Business database, Schneider (2005)

Note: Relationship is significant at the 1% level and remains significant when controlling for income per capita

Collective Impact of *all* Tax Instruments

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Direct:

Corporate Income Tax

Turnover tax

Personal tax: Sole Traders, Employees (who bears burden?)

Indirect:

Sales Tax (retail, cascading, etc)

VAT or GST

Import duties

Excise duties

Withholding taxes

Others:

Pension payments

Stamp Duties

Sub-national taxation by provinces and/or cities

Fixed fees / levies, sometime for specific services, sometimes not

Licenses 'used' as tax instruments

Zaqat (special case)

2. Metrics

Doing Business: Regional Data

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Economy	Paying Taxes						
	Rank	Payments (#)	Time (hrs)	Profit tax (%)	Labor tax & contributions (%)	Other taxes (%)	Total tax rate (% profit)
Oman	3	14	52	8.8	11.3	0.1	20.2
Jordan	18	26	101	15.3	12.8	3.9	31.9
Afghanistan	30	2	275	0	0	36.3	36.3
Iraq	47	13	312	9.4	29.2	0	38.7
Lebanon	54	21	208	11.9	24.9	0.5	37.3
West Bank Gaza	55	50	154	15.9	15.1	0.5	31.5
Syria	59	21	336	14.8	19.8	0.8	35.5
Yemen	89	32	248	30	10.4	7.6	48
Iran	96	28	292	16.7	26.7	3.1	46.4
Morocco	128	28	468	30.3	20.5	1.9	52.7
Tunisia	139	45	268	11.1	25.3	22.5	58.8
Pakistan	140	47	560	27	14.6	1.8	43.4
Egypt	144	41	536	12.9	28.9	8.6	50.4
Algeria	169	61	504	9.9	29.6	36.9	76.4

Diagnostic Tools to Analyze Tax as an Investment Climate Issue

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Policy

Average Effective Tax Rate

Marginal Effective Tax Rates

Comparison to **peer / competitor** economies crucial

And / or comparison over time

Administration

Ad-Hoc Surveys (quick and dirty, focus on key issues)

Structured surveys (compliance costs; using registered taxpayers, ICAs)

Doing Business, Enterprise Survey, etc

Tendency to forget about **informal sector**, however



FIAS have made heavy use of Marginal Effective Tax Rates (METRs): METR is...

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- NOT the *AVERAGE* Effective Tax Rate (AETR)!
 - AETR is the share of *total income* required to pay taxes
 - $AETR = \text{Taxes}/\text{Income}$
- METR is the share of the *before-tax rate of return* on a marginal capital investment required to pay *all* taxes
- One measure which encapsulates all tax and incentives for the investor on capital

METR Example

Say shareholders earns a 12% *before-tax* rate of return, but a 10% *after-tax* rate of return on an investment. Then

$$\text{METR} = (12\% - 10\%) / 12\% = 16.7\%$$

Comparative Regional METRs: FDI in Manufacturing

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Country	METRs	Corporate Income Tax Rate
Bahrain	9%	0%
Egypt	36%	20%
Oman	34%	30%
Yemen	55%	35%
Morocco	47%	35%
UAE	28%	0%
Saudi Arabia	32%	20%

METRs Useful for Evaluating 'Smart' Tax Incentives

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Relative Cost-effectiveness Ratios for Various Tax Incentives ^a		Scenarios			
		1 0% debt; greenfield project ^c	2 50% debt; greenfield project ^c	3 0% debt; 100% plant & equipment	4 50% debt; 100% plant & equipment
METR for benchmark tax regime ^b		57.0%	52.6%	59.0%	56.0%
1	Benchmark + Tax rate = 30% ^d	1.01	1.00	1.02	0.98
2	Benchmark + Tax rate = 15% ^d	0.99	0.92	0.98	0.90
3	Benchmark + Tax Holiday of 5 years	1.07	1.12	1.05	1.07
4	Benchmark + Tax Holiday of 10 years	0.96	0.88	0.95	0.85
5	Benchmark + Double Declining Balance	1.03	1.30	1.03	1.21
6	Benchmark + 20% ITC (no adjustment to basis) ^e	1.43	1.72	1.51	1.81
7	Benchmark + 50% IA (adjustment to basis) ^e	1.06	1.30	1.04	1.21
8	Benchmark + 50% IA (no adjustment to basis) ^e	1.05	1.07	1.03	0.96
9	Benchmark + Dividend Tax = 0%	1.02	1.07	1.02	1.05
10	Benchmark + Capital Gains Tax = 0%	1.00	0.81	1.01	0.84
11	Benchmark + Import duty on capital goods = 0%	1.03	1.22	1.03	1.21

Notes:

Source: Bruce Bolnick, (2004) "Effectiveness and Economic Impact of Tax Incentives in the SADC Region"



3. What is a 'good' tax environment?

Non-Smart v. Smart Tax Regime

- Has **many tax instruments** which raise very little revenue but have large compliance costs (Good or Bad ?)
- Focused on companies being **assessed & audited by Tax Authority** on a regular basis
- **High rates**, applied to a small % of businesses
- **Tax legislation changed frequently** in an un-coordinated manner – no private sector consultation.
- Has **many exceptions** and derogations for certain sectors, certain firms, certain regions
- Tax legislation is **vague and opaque** – leaving room for discussion and negotiation
- Tax Authority **overly focused on short-term revenue goals**, who harass existing taxpayers to meet those goals.
- No, or slow, and subjective **Appeals Process**
- Unclear taxation powers at the **sub-national level** leads to plethora of small levies.
- Has **few tax instruments** (direct and indirect) which are broadly applied.
- Instruments and rates not changed too frequently – substantial private sector discussion beforehand.
- Focused on **self assessment** by companies, coupled with risk based auditing
- **Rates are comparable to the region / peer economies** and broadly applied. Almost no exceptions or derogations
- Tax legislation is **simple yet precise** and comprehensive.
- **Tax Authority** is professionally managed, with broad range of service targets (not just revenue collected).
- Accessible and objective **Appeals Process** which is quick.
- **Sub-national government** have clear taxation powers, with similar principals to national (few instruments, broadly applied).

Role of Tax Incentives

- **Political Economy of Tax Incentives**
 - Why do we see so much of them in developing countries ?
 - Is it sustainable ?
 - Rules v. Discretion (a fine-tuned tax system is efficient but inequitable)
 - Who decides them (Ministry of Trade/Commerce or Ministry of Finance) ?
 - Role of Tax Expenditures ?

Smart v. Non-Smart Tax Incentive Regime

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Incentives:

- Use tax incentives to correct for **government failure** (macro instability, bad infrastructure, rule of law applied inconsistently, etc)
- Focus incentives on **FDI**
- Use **tax holidays** rather than performance based incentives
- Has tax provisions in **non-fiscal legislation**: in the Investment Act, line agency Legislation, creating an uncertain web of opaque incentives
- Application is **discriminatory**, through an application process open to abuse and corruption
- **Open ended incentives**: once created are never removed
- **Do not evaluate** their incentives

Incentives:

- Use tax incentives to **correct for clear market failures** (R&D, new export markets, public good infrastructure)
- Use **performance based incentives** such as Tax Credits , Allowances and Accelerated Depreciation
- All incentives are in the **relevant tax legislation** and very clearly explained
- Are automatically available to all businesses which meet very clearly defined criteria
- Include '**sunset**' clauses, after which they are evaluated and perhaps extended. Or use 'revenue envelopes'.
- Publish **tax expenditures**

4. Special issues: GST/VAT & SMEs

VAT and GST – Specific Problems and Opportunities

- Very good revenue raiser
- Non distortionary / not cascading
- Very popular...but...
- **High compliance burden for taxpayers (esp SMEs) and tax authorities**
- **Do they work in LDCs?**
- **Refund problems for exporters**

Takeaways

- **Taxes Do matter for Business**
- **Investment barriers can be measured**
 - **Tax Policy as a whole**
 - **Tax Administration**
 - **Other Administrative Barriers**
- **This allows benchmarking across countries and fixed goals than could be reached.**
- **Tax Incentives**
 - **Simple Tax Regime applied over all taxpayers is better than Tax Incentives**
 - **If Tax Incentives are used its costs and benefits must be measured**
 - **There are good Tax Incentives that link tax benefits to investment**

7. Responses: Q&A

Further Reading

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