



## Policy Brief on Impact of Tax Incentives in Rwanda

July 2011

# Tax Incentives for Investors: Investment for Growth or Harmful Taxes?<sup>12</sup>

**In just 2008 and 2009 Rwanda lost over \$234 millions due to tax incentives. Was the investment return worth it?**

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<sup>1</sup> This policy brief draws on Abbott, P. (2011) *The Impact of Tax Incentives in East Africa – Rwanda Case Study Report*. Kigali: Action Aid. The full report provides a list of references and the evidence on which this policy brief draws.

<sup>2</sup> The study was funded by and ActionAid International and carried out by a team of researchers at the Institute of Policy Research and Analysis-Rwanda. The authors alone are responsible for the content of this brief which does not necessarily represent the views of the funders or IPAR-Rwanda.

## **Introduction**

Every year Rwanda foregoes about a quarter of its potential tax revenue through tax incentives and exemptions given to businesses to attract private sector investment. Is this money well spent?

This policy brief looks at the issue of providing tax incentives and exemptions for investors:

- Are they too generous for a country like Rwanda that is struggling to raise money to fund its development strategy?
- Are they targeted at the right groups?
- Are they achieving the government's objectives for them? Would the money be better spent on other policy priorities like education or health?
- Why are the amounts foregone not made publically available?
- Why is there no monitoring and evaluation of their effectiveness and why has there been no cost benefit analysis of tax incentives for attract investment?
- Should the amount foregone be considered as part of the Government's budget so that it becomes transparent expenditure?

Whether tax incentives and exemptions work or not, there is a need for transparency, public scrutiny and dialogue; equity and bargaining are essential to building a culture of tax compliance. Accountability of government to citizens is essential, and taxation encourages citizens to make claims on governments and hold them accountable for public expenditure.

## **Issues**

Taxation is essential for sustainable development; it supports the basic function of a sustainable state and sets the context for economic growth. It is also essential for responsive government and enhancing downward accountability. Rwanda is heavily dependent on foreign aid and wishes to reduce this dependency by widening the tax base. A policy of giving tax incentives to investors would seem to be at odds with a policy of increasing tax revenues.

Yet Rwanda foregoes a significant (and unknown) amount of tax year each year amounting to what are in effect hidden expenditures. In other words Rwanda subsidises investment through the tax system. It is the most generous of the EAC countries in providing tax incentives for investment, foregoing about a quarter of its potential revenue each year in tax incentives for businesses, 14 per cent of its potential budget. The revenue foregone would be sufficient to more than double spending on health or nearly double that on education.

However, the amount 'spent' is not considered as part of the budget expenditure. There has been no systematic monitoring and evaluation of the extent to which they are working and the government has not systematically discussed the recommendations of external experts recommending that they be reviewed.

Furthermore, as a member of the East African Community, the government is committed to removing or at least harmonising ‘harmful taxes’. The expert review of taxes undertaken for the EAC concluded that there was a need to review all tax exemptions and concessions in member states, to harmonise them and to remove a number. There was a danger, the report warns, of a ‘race to the bottom’.

### **Background**

Tax exemptions and concessions given to business in Rwanda are seen as an integral part of government policies for developing an economy led by the private sector, part of a package of policy measures to attract private sector investment. Investment by government in private sector development through tax exemptions, amongst other policy measures, is part of a strategy for sustainable economic growth, economic transformation, and job creation.

### **Existing policies**

Rwanda has in place a complex system of tax incentives and exemptions for investors. The main beneficiaries are big businesses, many of which are foreign-owned, although domestically-owned businesses can benefit from some of the incentives and exemptions. The largest amount is exemptions on imported goods amounting to 84 per cent of the total while only 0.17 per cent is for employing Rwandans. The latter is generally regarded as a preferable type of incentive as it rewards output.

The provision of tax incentives for investors could be seen to be in conflict with the policy of widening the tax base and increasing domestic tax revenues to reduce dependency on official development aid. In furtherance of this policy it has been vigorously working to bring businesses operating in the informal sector into the tax net.

### **How much is lost in tax incentives?**

In 2006 according to the International Monetary fund the amount of revenue foregone in Rwanda to tax incentives was three per cent of GDP. Calculations from our research suggest that by 2008, this had risen to 3.6 per cent and 4.7 per cent by 2009. This compares with 2.8 per cent of GDP in Tanzania in 2008/9; one per cent of GDP in Kenya and 0.4 percent in Uganda.

Exemptions on imported goods provide by far the largest category, 84 percent of the total. By contrast the percent of the total tax foregone for providing employment for Rwandans was 0.17 per cent.

**Table: Tax Foregone Due to Tax Incentives 2008 and 2009<sup>3</sup>**

<b>Tax</b>	<b>2008 Tax Foregone (Rwf)</b>	<b>USD</b>	<b>2009 Tax Foregone (Rwf)</b>	<b>USD</b>
Investment Allowance			21,826,890,607	36,291,052.49
Tax Reduction Based on Number of Employees	259,265,691	431,074.91	237,037,365	394,116.40
Corporate Income Tax at 0% for 5 Years (Micro Finance)	529,065,477	879,664.60	61,512,331	102,275.09
Import Tax Exemptions (VAT, Customs Duty, Withholding Tax)	92,211,995,534	153,318,694.36	118,193,608,019	196,517,704.21
Domestic Tax Exemptions resulting from contracts based in bilateral agreement e.g. COMESA	1,378,873,200	2,292,619.71	536,700,600	892,359.34
<b>Total</b>	<b>94,379,199,902</b>	<b>156,922,053.57</b>	<b>140,855,748,922</b>	<b>234,197,507.52</b>
As % Total Tax Revenue	34%		38%	
As % Total Potential Tax Revenue	25.5%		30%	
As % Total Government Revenue	29%		33%	
As % Total Potential Government Revenue	22.5		24.7	
As % of Government Budget	14%		17%	
As % Total Potential Government Budget	12.3%		14%	
Total as % of GDP	3.6%		4.7%	

(Source: Calculation Provided by RRA April 2011)

### **Are Tax incentives Working?**

There is evidence of a significant increase in private sector investment following the introduction of the revised tax code in 2005. This has resulted in the creation of new jobs. Exports have increased and there is some evidence of a beginning of export diversification into areas prioritised by the government as well as an increase in revenues from tourism. However, the government remains dependent on ODA for about half its budget.

<sup>3</sup> We noticed that the data in this table does not match exactly to types of taxation in Rwanda. We checked the information with RAA and were assured it was accurate.

Evaluating the effectiveness of tax incentives and exemptions is, however problematic, especially those aimed at attracting investment, because of a number of confounding factors making it difficult to do a cost-benefit analysis. Rwanda has been investing in: ensuring the rule of law and the absence of systematic corruption; improving the ‘soft’ business infrastructure; the physical infrastructure; and the availability of skilled workers. All of these are said to have more influence on business investment decisions especially foreign investors than the availability of tax incentives and exemptions. The latter are, it is argued, at best a second-order consideration. It is not possible to disentangle the impact of these from tax incentives and exemptions.

Our analysis of the costs of benefits of providing tax incentives for businesses including attracting FDI and domestic investment is inconclusive, but there is a growing consensus that tax incentives may not work, or to the extent they do they have to be used selectively and for a limited period.

### **Recommendations**

The government needs to balance supporting investment by providing a competitive tax environment and ensuring that investors pay an appropriate share of the fiscal revenue. There is a need to protect the tax base against sophisticated tax planning, that is, businesses avoiding taxation by taking advantage of incentives and then moving when they are no longer entitled to them. It should also be noted that once they are introduced, it is difficult to remove tax incentives. The Rwandan government should consider:

1. developing an efficient and effective personal and corporate tax system that is transparent and fair to all;
2. publishing comprehensive information on all tax exemptions in an annex to the annual budget giving details of the amount of revenue foregone due to tax incentives and exemptions;
3. putting in place mechanisms to monitor and evaluate tax incentives;
4. carrying out a cost-benefit analysis of tax incentives for business
5. reviewing the tax incentives that it offers and the list of goods that are exempt from VAT;
6. working with the other members of the EAC to harmonise taxes including tax incentives and exemptions.