



REALIZING THE POTENTIAL FOR PROFITABLE INVESTMENT IN AFRICA
High-Level Seminar organized by the IMF Institute and the Joint Africa Institute
TUNIS, TUNISIA, FEBRUARY 28–MARCH 1, 2006

Strategies for Improving the Incentive Structure of Tax Systems A Southern African Perspective

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Paper presented at the high-level seminar: *Realizing the Potential for Profitable Investment in Africa*
Organized by the IMF Institute and the Joint Africa Institute
Tunis, Tunisia, February 28 – March 1, 2006

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Realising the Potential for Profitable Investment in Africa
Tunis, Tunisia - 28 February to 1 March 2006

STRATEGIES FOR IMPROVING THE INCENTIVE STRUCTURE OF TAX SYSTEMS

A Southern African Perspective



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28 February 2006



What Are Tax Incentives?

General Tax Incentives (e.g. Accelerated depreciation)

- Apply to all investments
- Designed to function as incentives
- Should be marketed by Governments as such
- A common trend internationally, introduced with the intention to stimulate investment

Selective Tax Incentives (e.g. Export Processing Zones)

- Used to attract both local or foreign investment
- Directed at specific economic activities (a favourable deviation in taxation treatment from other investments)
- Generally in particular areas of a country



Advantages of Tax Incentives

Advantages –

1. Greater profits – investors enjoy higher rate of return, hence more to re-invest
2. Spin-off effects – as a result of knowledge accumulation & innovation
3. Practicality – influences, apart from revenue raising, other policy objectives, e.g. job creation, development of disadvantaged regions
4. Positive signal – can signal a Country's commitment to facilitating investment
5. Capital mobility – effective tax rate on capital has to be low to attract an inflow of foreign investment and keep domestic savings at home
6. Tax competition – introduce similar breaks or lose the investment
7. Compensating for other deficiencies – unreliable or high cost infrastructure, macro-economic instability or a weak legal and judicial system
8. Revenue gains – if in the absence of incentives an investor will go elsewhere there is no direct revenue loss, but indirect revenue gains may be favourable, e.g. job creation etc.
9. Political cover – cost of tax incentives is less visible than investment policies involving explicit budget outlays
10. Experience shows that incentives can work! Examples of where tax incentives have worked well are often quoted



Disadvantages of Tax Incentives

Disadvantages –

1. Revenue loss – foregone revenue is merely taxed in the investors country of residence or tax favoured investors take business away from taxable investors
2. Revenue leakage through avoidance and evasion – abusive tax avoidance schemes aided by tax preferences, further erodes the revenue base
3. Impact on tax administration – divert resources from revenue collection and enforcement action directed at investors subject to a non-preferential tax regime
4. Economic cost of fiscal adjustments – revenue losses arising from tax incentives often end up being a burden carried by other taxpayers or Government utilises other costly forms of financing
5. Economic distortions – may reduce efficiency and productivity
6. Equity – inequities are created which can undermine general compliance
7. Lack of transparency – tax incentives score poorly in terms of transparency and accountability
8. Political dynamics – the cash value of tax incentives may stimulate political manipulation and corrupt practices
9. Other instruments – can be more favourable and can have lasting effects
10. Experience shows that incentives usually don't work! – cases where unfavourable results arose can be demonstrated



An Overview in the SADC Region

The Most Popular SADC Tax Incentives –

<u>Country</u>	<u>Incentive Count</u>	<u>Initial Capital Allowance</u>	<u>Preferential Tax Rates</u>	<u>Tax Holidays</u>	<u>Special Export Incentives</u>	<u>Accelerated Depreciation</u>	<u>Training & Employment</u>	<u>Investment Tax Credit</u>
Angola	3		1	1		1		
Botswana	4	1	1	1			1	
DRC	4	1		1	1	1		
Lesotho	2		1				1	
Malawi	5	1	1	1	1		1	
Mauritius	6	1	1	1	1	1		1
Mozambique	6	1	1	1	1	1		1
Namibia	6	1	1	1	1	1	1	
Seychelles	4	1	1		1	1		
South Africa	5	1	1		1	1	1	
Swaziland	6	1	1	1	1	1	1	
Tanzania	3	1		1	1			
Zambia	5	1	1	1	1	1		
Zimbabwe	6	1	1	1	1	1	1	
TOTALS		12	12	11	11	10	7	2

Source: SADC Tax Database - 2003



Initial Capital Allowances (12)

Analysis –

- Several SADC countries offer 100% write-off in the first year
 - Most common categories relate to farm works and mining investments
- Tanzania allows for 100% write-off for approved investments in lead sectors
- Mozambique recently introduced 100% write-off for technology equipment
- Other ICAs in the region range from 10% to 60%, covering – industrial buildings, export manufacturers, computer equipment, tourism and hotels, small industry, agriculture and entities operating within certain designated regions
- South Africa offered a Strategic Investment Project (SIP) program offering the ICA as an additional allowance



South Africa's SIP Program

Analysis –

- Introduced in November 2001
- Coherent targeting (applying a scoring system):
 - New projects in manufacturing, computer technology and R&D
 - New products or processes favoured
 - Value added
 - Procurement from SMMEs
 - Infrastructure provision
 - Full-time jobs created per R1m of investment (heavily weighted for job creation)
- Attractive benefits – 50% or 100% ICA in addition to accelerated depreciation
 - Substantially lowers METR for most projects
 - Yields revenue in medium term
- Cost limits
 - Ceiling per project of no more than R600m
 - Cumulative total of ICA in terms of the program may not exceed R10bn
- Transparent
 - Qualifying criteria are explicit, applications gazetted, awards reported and costs monitored
- Claw-back provision – non-compliance provides for possible tax penalties



South Africa's SIP Program (cont)

Weaknesses –

- Minister of Trade and Industry has some discretion regarding qualifying projects
- Critical job criterion includes “indirect jobs” – easy to manipulate and difficult to substantiate
- Program favours projects with rapid payback period and projects run by companies with other industrial income against which to offset tax allowances in the early years

Current Status –

- Program discontinued in 2005



Preferential Tax Rates (12)

Analysis –

- Most SADC countries offer preferential tax rates to certain companies
- In some instances the beneficiaries can obtain complete exemption:
 - EPZ companies in Namibia, Malawi and Zambia
 - Global financial services companies in Mauritius
 - Offshore companies established in the Seychelles
- Other rates range from 10% to 25%, most frequent encountered being 15%
- Sectors targeted:
 - Agriculture
 - Manufacturing
 - Mining
 - Small business



Tax Holidays (11)

Analysis –

- Regarded as a poor instrument for stimulating sound and sustainable investments
- Very popular in the SADC region (Lesotho and South Africa have had tax holiday programs in the past)
- Most common tax holiday period is 5 years (range from 3 to 20 years)
- Beneficiaries normally include exporters, priority industries, manufacturers and companies in particular geographical locations

Dangers –

- Generally have a perverse effect – a reverse fiscal subsidisation to the Government in the country in which the investor is resident
- The tax forgone by the tax holiday grantor is usually then collected by the Treasury of the country in which the investor resides
- Can be protected with a “tax sparing” clause in an agreement for the avoidance of double taxation (although treaty partners are usually not interested in permitting tax sparing)



Special Export Incentives (11)

Analysis –

- Either exempt from tax or tax rate reductions in “free trade zones”
- Malawi offers an allowance of 12,5% of gross export sales as a deduction
- Namibia and Mauritius allow exporters additional deductions for export marketing and promotion costs
- South Africa offers special export tax incentives through the Motor Industry Development Program (MIDP). This incentive does not provide for deductions against taxable income but rather through import duty credits that are granted as a function of the domestic content of export sales

Caution –

- The scope for targeting tax incentives to exporters is constrained by the WTO Agreement on Subsidies and Countervailing Measures (SCM)



Accelerated Depreciation (10)

Analysis –

- “Accelerated” where write-off rate exceeds the real economic rate of capital consumption
- Generally applicable to plant and equipment utilised in manufacture
- Zambia offers 50% over two years
- South Africa offers a 40:20:20:20 write-off over four years
- Namibia offers 33,3% per year for mining and petroleum



Deductions for Training and Employment (7)

Analysis –

- Botswana and Swaziland offer a 200% deduction for qualifying program participants
- Other additional deductions over cost are offered by Malawi (50%), Namibia (25%) and Lesotho (25%)
- South Africa offers a Learnership Allowance in conjunction with a Skills Development Levy equalling 1% of payroll. This levy is then utilised to support training programs



Investment Tax Credits (2)

Analysis –

- The least popular form of tax incentive in the SADC region is the investment tax credit
- In Mauritius several categories of investment qualify for a 10% ITC, subject to the condition that the tax payable is no lower than 15%
- Mozambique's major tax reform program of 2002 adopted ITCs as a central instrument for stimulating investment. The amount of the ITC ranges from 5% to 30% depending on sector, location and size of investment



Successes and Failures

Experience with tax incentives in the SADC region is distinctly mixed.

In some circumstances, tax incentives have helped to stimulate important investments

- Best known example is the “Mauritius Miracle” where generous tax benefits are widely regarded as having played an essential part in attracting investment
- Lesotho has had considerable success in job creation in export manufacturing combined with the AGOA provision that allows low-income African countries to have duty-free access to the American market for garments made from third-country fabrics
- Tax incentives were essential in bringing the giant Mozal aluminium smelter into Mozambique
- In South Africa, the MIDP program is widely regarded as a success in stimulating investment and rapid growth in automotive exports
- The Ramatex textile factory in Namibia unquestionably based its location decision on an incentive package
- In Botswana, the government considers its 15% tax rate for manufacturers as reasonable successful



Strategies for Successful Tax Incentives

1. Understand the conditions in which tax incentives are likely to succeed or fail
2. Design tax incentives that will maximise the positive effects and minimise the negative effects

HOW?



General Considerations

1. Non-tax factors are far more important than tax incentives in determining the level and quality of investment flows
2. The effect of incentives on productivity and efficiency is at least as important as the effect on the amount of investment
3. Investment tax incentives work well in some countries and poorly in others (decisions about tax incentives should be country specific)
4. The benefits of investment incentives are widely exaggerated, while the costs are widely underestimated
5. Capacity building to strengthen tax policy analysis should be a central priority (prior to implementation and post implementation)



Specific Considerations

1. Avoid zero tax rates – the vast majority of viable investment projects do not hinge upon exemption from tax
2. Tax holidays are less cost effective
 - Revenue loss is high
 - Favour transitory rather than sustainable investment
 - Create opportunities for aggressive tax avoidance
 - May subsidise the Treasury of the country in which the investor resides
3. Most cost-effective tax incentives are the investment tax credit and initial capital allowance
 - Large reduction in METR relative to revenue cost
 - Minimum of administrative complexity
4. Location-dependent investments that are fundamentally viable, especially resource-based projects, should not receive special tax preferences. On the contrary, governments should negotiate carefully to capture a fair share of resource-extraction rents



Thank You

Acknowledgement

A technical report entitled *Effectiveness and Economic Impact of Tax Incentives in the SADC Region* prepared by Dr. Bruce Bolnick of Nathan Associates Incorporated.

Feb 2004