Institute of Policy Analysis and Research - Rwanda

actionaid

Policy Brief:

CORPORATE TAX INCENTIVES IN RWANDA:

Taxes for improved public services and sustainable development

1.Introduction

THIS POLICY BRIEF aims to assess the direct benefits and costs of corporate tax incentives given to attract Foreign Direct Investment(FDI) in Rwanda and their implications on revenue collection, service delivery and job creation over time.

The motivation behind the study that informed this policy brief is to advise policy makers on strategic allocation and monitoring of tax incentives in ways that will promote investment and job creation in key sectors without compromising the size of domestic tax base.

The timing of this study is in line with other regional and international initiatives that have been implemented to curb the flow of illicit financial flow from Africa including the Africa Union-commissioned Mbeki report.

There has been international and continental concerns that Africa is still a net creditor to the rest of the world. Despite the inflow of official development assistance, the continent had suffered and was continuing to suffer from a crisis of insufficient resources for development and was annually losing more than $50 billion through illicit financial outflows (AU Mbeki report, 2011).

Large commercial corporations are by far the biggest culprits of illicit outflows given that they have the means to retain the best available professional, legal, accountancy, banking and other expertise to help them perpetuate these flows. Proponents of corporate tax incentives argue that tax incentives are key to attracting Foreign Direct Investment (FDI) and job creation.

> “So far, no curriculum has been developed on Early Childhood Development, leaving children exposed to different ways of instruction. More over, there are a few, if any, teachers who are qualified as nursery school instructors.”

However, opponents argue that the job creation should not come at the expense of multinational corporations paying a fair share of their taxes to support the development of the physical infrastructure and human resources they use in their production processes in host countries.

1.1 Progress made in the Implementation of the Tax Reforms and Investment Code in Rwanda

As a result of Actionaid and Tax Justice Network Africa's 2011 study related to tax incentives coupled with the need to become more self-reliant, the government of Rwanda is closely monitoring and implementing the lapse periods of tax incentives given to companies over time in order to expand the domestic tax base.

This was not the case prior to 2011, where tax incentives although time bound, were not monitored closely, leading to companies perpetually asking for incentives beyond the initial five year period.

In addition, some companies tended to abuse the tax incentives by changing ownership and re-branding after the initial five year period, thus registering for fresh exemption periods. In addition, Rwanda has been striving to update the Investment Code whilst maintaining its attractiveness for foreign direct investment.

However, following recommendations of Actionaid, Tax Justice Network study and the country's need for self reliance, the Investment Code has been changed largely relating to scrapping of various tax incentives while maintaining them in strategic sectors like energy and ICT.

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2.Methodology

The methodology for this research project entailed both qualitative and quantitative methods. Qualitative methods entailed conducting key informant interviews with government ministries and regulatory agencies, private sector actors and development partners.

Quantitative research was done by analyzing tax data provided by Rwanda Revenue Authority. We analyzed the direct benefits (i.e. corporate income taxes) against the costs incurred with the taxes foregone from incentives given to corporations in Rwanda using both quantitative and qualitative methods.

In addition, we analyzed the trends in allocation and composition of these incentives over time. Lastly, we analyzed the revision of the Double Taxation Agreement (DTA) between the Rwandan and Mauritian governments in order to determine the implications for Rwanda and the wider East African Community.

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3.Research Results

3.1 General trends in Losses due to Tax incentives in Rwanda over Time

Our findings show that over the last 10 years, Rwanda has foregone 349bn Rwf they could have collected in corporation tax (17% of the total tax take), and only collected 307.8bn Rwf (15% of the total tax take). If they could have collected the corporation tax that was foregone due to tax incentives, corporate tax would have made up 27.3% of domestic revenues instead of 15% (See Appendix 1 in the report). Although corporate taxes in Rwanda have increased steadily from about 18.5 billion Rwandan francs (Rwf) in 2002 to Rwf 104.5 billion in 2013, total taxes foregone due to incentives have grown much faster starting from Rwf 6.8 billion in 2002 and reaching Rwf 110.3 billion in 2013. Except for the years 2002 and 2003 in which the net direct benefits of corporate tax exceeded the total costs of taxes foregone by 11.6 and 2.9 billion Rwf respectively, the rest of the years have seen negative returns in terms of taxes foregone and corporate taxes collected. Over the 10 year period spanning the calendar years 2002 to 2011, the net loss (after deducting the benefits of revenues from corporate tax) from taxes foregone due to tax incentives and exemptions was 82.8 billion Rwandan francs. This translates into an average of about 8.3 billion Rwf lost due to tax incentives annually (See Appendix 1 in the report).

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3.2 Allocation of tax incentives

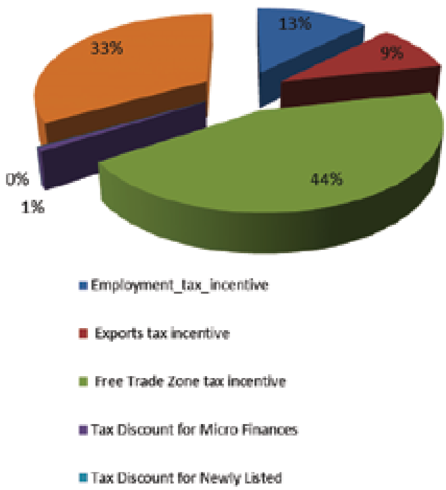
Our findings further show that although tax exemptions and incentives accruing from the provisions of the customs law have been the dominant sources of revenue losses over the last 10 years, tax exemptions claimed for industrial inputs have been generally very low (See Appendix 1 in the report). This is a major point of concern. Given that job creation is one of the driving factors to providing tax incentives, the government needs to re-direct its existing incentives to the most potentially productive sectors (like manufacturing and agro-processing) which generate more employment when compared to the service sector. For instance, incentives going to manufacturing, a sector with a very high potential of generating jobs for low-skilled workers in Rwanda, have been low. Given that fewer incentives are claimed for intermediate inputs or raw materials going into manufacturing, it implies the service sector may be the major beneficiary of customs law and investment code exemptions yet the service sector has a lesser impact on job creation for the majority low-skilled workers in Rwanda.

3.3 A Critical Analysis of a Sample of 50 Companies that received Tax incentives in Rwanda in 2010/11

3.3.1 Alignment of Incentive allocation with National Development Priorities

Findings further show that the way incentives are allocated is not well aligned to objectives that benefit the wider society. Despite the fact that a relatively high proportion of companies received employment incentives, employment incentives amounted to about Rwf 629 million which accounts for just 12.5% of the total incentives received by the sampled 50 companies in terms of magnitude. The same story applies to export incentives which amounted to about Rwf 460 million, accounting for just 9% of the total incentives received. A single company that invested in the free trade zone accounts for about 45% of the incentives given that year. Over one half of the sampled companies did not meet their employment creation objectives thus missing out on the employment tax incentive. In terms of exports incentives, only 16% of the companies benefited from incentives that accrue from meeting a threshold amount of exports in a given year while 14% benefited from incentives of being newly listed. Only one of the 50 sampled companies in 2010/11 benefited from incentives that accrue from investing in a free trade zone while 4 out of the 50 companies benefited from bringing in venture capital into Rwanda (See figure 1 below). If tax incentives were to be more beneficial to wider economy, you would expect a higher proportion of incentives received for employment creation and exports in terms of magnitude. We recommend that a higher percentage of those incentives offered be allocated to employment generation, which would then give a good signal to employers to put more efforts into job creation.

Figure 1: Tax incentive shares for sampled 50 recipients of 2010/11



More weight should be directed to job creation, in country re-investments and capacity building when allocating tax incentives during the gradual phase out of these incentives in Rwanda.

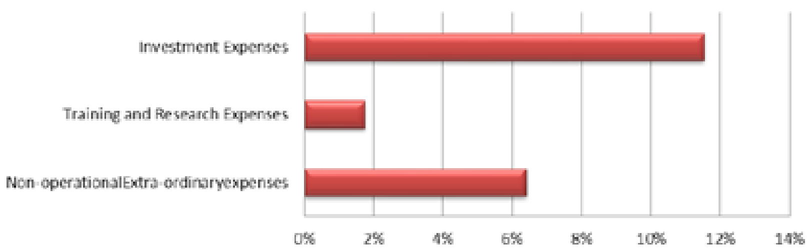
3.3.2 Re-investment and capacity building

A closer look at the expenses section of the 50 sampled companies that received tax incentives in 2010/11 shows that Rwanda is not benefiting much in terms of re-investment and capacity building of local employees among companies that receive tax incentives. For the 50 sampled companies that received tax incentives in 2010/11 only 12% of their total income was spent on further investments into the country, while a meager 2% of the companies' income was spent on research and training. Despite the low spending on investment and training, there is a substantial expenditure on non-operational extra-ordinary expenses.

This expense item is not clear and it could be one of the ways that companies misprice their operations by inflating their expenses in order to reduce their taxable income and subsequently, their tax obligations to the country.

More clarity is required to assess what is meant by non-operational extra-ordinary expenses and how it relates to potential mispricing of company expenses. In addition more weight should be directed to job creation, in country re-investments and capacity building when allocating tax incentives during the gradual phase out of these incentives in Rwanda.(See figure 2 below).

Figure2: Expense breakdown as a ratio of Total income for the sampled 50 receipients of Tax incentives in Rwanda in 2010/11



	Non-operationalExtra-ordinaryexpenses	Training and Research Expenses	Investment Expenses
Series1	6%	2%	12%

3.4 The opportunity cost of tax incentives given to companies in Rwanda

The opportunity cost shows the alternative items on which the government would have spent the foregone tax revenues if they had been collected. Table 1 below shows that the net loss due to tax incentives for all the companies that received tax incentives in 2010/11 was about Rwf 32 billion.

The government budget is funded from three sources: domestic revenues (Rwf 479.7b), Official Development Assistance(ODA) (Rwf 409.2b) and borrowing (Rwf 95b) (Law No 30/2010 of 3006/2010).

So the government could have eliminated the need to borrow or relied on less foreign aid.

Alternatively it could have increased spending on priority areas. In terms of EDPRS priorities in the 2010/11 Budget, 24.6% was allocated for infrastructure, 14.2% for productive capacity, 33.9% for human development and social sectors, 30.1 % for governance, 4.5% for defence and 5.1% for public order and safety (www.minecofin.gov.rw).

It could have increased spending on the agricultural sector by about 50%. It could have increased spending on industry and commerce by about 60% in 2010/11.

Table 1: Net taxes foregone from all companies that received tax Incentives in 2010/11

Total duties & taxes foregone	Total duties and taxes paid	Net loss due to tax incentives in Rwanda
33,218,282,214	1,285,902,913	-31,932,379,301

Source: Data from Rwanda Revenue Authority 2013

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4. Conclusions & Recommendations

- This policy brief has shown that the returns on tax incentives and exemptions with respect to corporate taxes have been negative over the last 10 years in Rwanda. Given Rwanda's ambition of self reliance, tax exemptions and incentives given to corporations need to be re-assessed and allocated more strategically in sectors that will increase employment and widen the domestic tax base in Rwanda.

- Although the broad literature shows that tax exemptions are not the main drivers of investment, some incentives, especially those that support local agro-processing industries, need to be maintained and given in a transparent manner in order to promote local manufacturing which will provide the needed 200,000 non-farm jobs annually. Local incentives for local manufacturing and agro-processing should be accompanied by investments in energy and road infrastructure.

  In order to create adequate jobs which will take up the majority of low skilled and unskilled workers in Rwanda, manufacturing which includes agro-processing is a key sector. It is crucial that industrial input incentives for the agro-processing sector be made accessible to domestic as well as foreign agro-processing industries in Rwanda. If tax incentives were to be more beneficial to the wider economy, you would expect a higher proportion of incentives

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- The performance of the companies in terms of taxes collected, jobs created, profitability and re-investments in the country needs to be monitored regularly in order to determine both the lapse period for the tax exemptions and the value for money from the tax incentives. In addition, there is a need to reach a good balance between promoting the local private sector growth and widening the revenue base.

  The majority of the beneficiaries from tax exemptions have generally been foreign multinationals, leaving out local industries which have sometimes lamented the unfair competition. The sectors of agro-processing, ICT and tourism especially those owned by domestic investors, need to be incentivized in order to promote a levelled playing field between domestic and foreign investors.

- Findings from our case study analysis show that there is need for more vigilance and transparency in transactions involving transfer of ownership especially when multinational companies are involved in order to help the government benefit from capital gains tax that accrue during such transactions. In addition, tax incentive agreements need to be reviewed each time such transactions take place to avoid perpetuating losses from un-ending tax incentive agreements.

- The successful revision process of Rwanda's Double Taxation Agreement (DTA) with Mauritius can be a model for other African states to boost the revenue bases and close some of the loopholes that Multinational corporations use to avoid paying taxes in host countries. Our case studies show that governments do not necessarily need to worry about amendments of DTAs scaring away investors since many investors will continue to invest under new treaty terms.

Appendix 1: Comparing the Costs and Benefits of Tax Incentives given to Corporations in Rwanda

Calendar Year	COSTS				BENEFITS		BENEFITS LESS COSTS
	Revenues Foregone due Tax exemptions in Rwanda				Taxes collected		
	Customs law (1)	RDB Investment Code (2)	Industrial inputs (3)	Total Revenues Foregone(3)	Total Corporation[1] Taxes) (4)	Total revenues collected(5)[2]	Corporation tax-Total Revenues foregone (6)
2002	5,115,268,257	1723164434	0	6,838,432,691.03	18,453,682,146	94,752,947,612	11,615,249,455
2003	9,717,606,869	4214417749	1,099,087,187	15,031,111,805.23	17,956,939,968	115,319,734,395	2,925,828,163
2004	14,912,151,445	4,535,478,651	993,438,209	20,441,068,304.91	16,056,403,729	134,715,130,511	-4,384,664,576
2005	18566532425	5,257,271,908	1,660,522,397	25,484,326,730.09	24,439,401,142	162,618,245,101	-1,044,925,588
2006	23033679185	6,142,865,918	2,812,359,855	31,988,904,958.00	27,978,596,597	194,981,361,576	-4,010,308,361
2007	29881556243	15,294,750,582	2,448,446,810	47,624,753,635.36	35,754,121,744	239,223,731,867	-11,870,631,891
2008	36405083953	30,272,993,664	3,969,425,333	70,647,502,950.63	56,523,266,692	329,748,443,853	-14,124,236,259
2009	44,854,798,923	37,965,430,381	3,565,168,042	86,385,397,346.41	52,949,563,995	364,019,321,191	-33,435,833,351
2010	42,389,958,431	29,635,279,356	2,970,668,721	74,995,906,508.62	56,921,886,841	413,007,687,177	-18,074,019,668
2011	44,924,577,500	32,975,569,401	3,102,198,970	81,002,345,870.59	70,608,063,201	505,004,098,655	-10,394,282,670
Totals	269,801,213,232	168,017,222,044	22,621,315,525	460,439,750,801	377,641,926,055	2,553,390,701,939	-82,797,824,746
Fiscal years							
2009/10	37,178,305,300	27,937,285,887	3,449,849,590	68,565,440,776.60	54,633,367,921	376,822,803,491	-13,932,072,856
2010/11	44,925,621,100	31,262,233,689	2,715,773,822	78,903,628,611.42	65,224,957,768	473,908,989,613	-13,678,670,843
2011/12	47,051,423,727	40,988,450,301	3,575,203,103	91,615,077,130.49	83,468,180,504	556,002,686,863	-8,146,896,626
2012/13	51,190,713,741	57,313,575,348	1,786,610,347	110,290,899,436.23	104,460,713,635	651,921,563,602	-5,830,185,801
Totals				349,375,045,955	307,787,219,828	2,058,656,043,569	-41,587,826,127

Source: Data from Rwanda Revenue Authority (2013)

1 Total Corporation taxes includes Corporate Income Tax, Personal Income Tax, Withholding tax, penalty on Income tax and Arrears recovery

2 Total revenues collected = Taxes on income , profits and capital gains (including PIT, CIP, withholding tax and penalties) plus Taxes on property plus Taxes on goods and services plus Taxes on International trade and transactions