# DOES A COUNTRY'S TAX STRUCTURE DETERMINE ITS FOREIGN DIRECT INVESTMENT FLOWS? EVIDENCE FROM TANZANIA

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Abstract: This paper is about a country's tax structure to Foreign Direct Investment (FDI) inflows using Tanzania as a case study. In essence it is argued that the tax structure and the type of incentives offered by a country can be a major determinant of FDI inflows for third world countries. The paper is divided into six sections. In the introduction, a general overview of incentives is discussed. The general objectives of tax incentives are discussed in part two while their classification is made in part three. Part four deals with the general overview of tax structure in Tanzania. Incentives offered by the country are discussed in part five whereas the paper concludes by pointing out some investment risks that may hinder the inflows of FDI into the country and other factors that can be equally important in attracting FDI inflows.

## INTRODUCTION

Over the past two decades, most African governments have been actively promoting their countries as investment locations to attract scarce private capital and associated technology and managerial skills. All these efforts are targeted to help those countries to achieve their development goals. They have increasingly adopted measures to facilitate Foreign Direct Investment (FDI) inflows. Examples of such measures include liberalization of laws and regulations for the admission and establishment of foreign investment projects; providing guarantees for repatriation of investments and profits; and establishing mechanisms for the settlement of investment disputes. Tax incentives are also part of those promotional efforts.

Tax incentives can be defined as any incentive that reduces the tax burden of enterprises in order to induce them to invest in a particular project or sector. They are exceptions to the general tax regime of a country. Tax incentives would include such thing: s reduced tax rates on profits, tax holidays, a :ounting rules that allow accelerated deprecia.ion, and loss carry forwards for tax purposes. Others are reduced tariffs on imported equipment, components and raw materials, or increased tariffs to protect the domestic market for import substituting investment projects.

Advocates of tax incentives point out to their extensive use in some high-growth Asian economies as positive evidence of their effectiveness. However, Tanzi and Partha (1992) argue that this positive association probably has less to do with the nature of the incentives themselves than with characteristics of the countries where they are used such as quality of the civil servants and the efficiency of the public bureaucracy. Such characteristics, they point out tend to minimize the political-economy costs of providing incentives.

Most countries irrespective of their stages in development employ a wide variety of incentives to realize their investment objectives. Developed countries however more frequently employ financial incentives like grants or subsidized loans. Financial incentives are direct drain on the government budget and are generally not offered by developing countries to foreign investors. Instead, these countries tend to use fiscal incentives that do not require upfront use of government funds.

In Tanzania, the country offers a well balanced package of investment incentives to investors. Generally the package has been designed to:

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compensate and reward investors for their entrepreneurship, match the changing needs of the country, channel investments in the direction most needed for economic development and ensure growth with social equity. There are numerous incentives that are offered by the country for holders of Certificates of Incentives granted by the Tanzania Investment Centre (TIC). Most of them are geared towards priority areas and lead sectors. The investment incentives include tax relief and concenssional tax rates that can be accessed only by the investor under the income tax act of 1973, Customs tariff act 1976, VAT Act, 1997, Immigration Act, 1995 and other taxation statutes.

It is evident that from 1997 up to 2001, there were substantial increment of FDI inflows to Tanzania. For instance, in 1997 it amounted to 157.5 million dollars, in 1998 to 172.2 million dollars, 1999 to 183.4 million dollars in 2000 to 192.8 million dollars and 2001 to 224 million dollars[2] Such substantial incremental of FDI into Tanzania which is relatively low compared to that of Uganda but higher than Kenya poses the question of whether is it a result of the tax incentives offered by Tanzania or there are more issues of interest to be addressed.

## GENERAL OBJECTIVES OF TAX INCENTIVES

There are several reasons for which a country may decide to offer tax incentives to investors. The objectives may be categorized into different classes as follows. To channel the investments in a certain particular area for promotional of regional development. For instance a country may decide to build an industrial centers away from the cities and reduce environmental hazards, over urbanization and concentration of population.

Countries like Angola, Brazil, Ecuador, Ghana, India, and Pakistan are examples of countries that use such incentives according to Asit Advisory Studies (2000). In Nigeria for example there are regional incentives ranging from 100% - 5% to companies that establish operations in rural areas where there are no facilities like electricity, tarred roads, telephone and water supply.

Technology transfer has been another concern of most countries in granting tax incentives. Countries like Singapore and Malaysia have specific set of incentives directed towards research and development (R&D) activities and technology projects. Such exemptions include tax exempt technology development funds and tax credit for expenditures in R&D. Similarly cooperation and partnerships agreements among firms for R&D are often exempt in developed countries like US and member sates of EU.[3]

Some countries use tax incentives so as to promote sectors of industries or activities considered of crucial importance for the development. These may be targeted at say mining sectors, export-led activities and business with new technologies. Singapore for example provides exemption for Income Tax for five years to pioneer companies involved in industries that are not adequately developed in the country. Similarly Tanzania provides capital allowances of 100% in respect of capital expenditure incurred by people engaged in mining operations.[4] In Pakistan, High-Tech industries which include power tools, IT and solar energy utilization benefit from wider range of fiscal incentives.

As noted earlier, incentives can also be targeted at many types of activities such as export promotion, employment/ skills training and Domestic Value Added. Free Trade Zones (FTZ) typically cover incentives for export oriented manufacturing. A good example is Ghana where companies engaged in export of non-traditional products are taxable at a reduced rate of 8%

[2] *See UNCTAD World Investment Report, 2002.*

[3] *See UNCTAD, World Investment Report, 1997: 205-208*

[4] *See Income Tax Act 1973, part III of the second schedule*

instead of the standard 35%.[5]. Similarly in Tanzania, for the purposes of promotion of exports, all exports are liable to VAT at a zero rate instead of standard rate of 20%,[6] provided that there is evidence of exportation.

CLASSIFICATION OF TAX INCENTIVES

Incentives offered by different countries are categorized under different classification. Reduced corporate income tax rates involves exception to the general tax regime so as to attract FDI in specific sectors or regions. Hong Kong, Indonesia, Ireland Cambodia are few examples of countries that use this type of incentives.

Alternatively, or in addition to corporate income tax, investors may be allowed to carry forward the losses. The measure is particularly valuable to investors whose projects are expected to run losses for the first few years as they try to increase production and penetrate the markets. Accelerated depreciation may as well be incentive to investors because it allows them to reduce their tax burdens in the years immediately following investment when cash flow is important in order to pay off the debt. Taken together, these measures are most desired by foreign investors.

Advocates of tax incentives suggests that tax holidays to be a common form of tax incentive used by many countries, Clack (1999). Under tax holiday-type of incentive, 'newly established firms' are exempted from paying corporate tax for specified period of time (say five years). These firms may be as well exempted from other types of taxes. Tax holidays eliminate tax on net revenues from investment projects over the holiday period, which, depending on the case considered, may encourage investments. This is viewed by many countries as simple incentive with relatively low compliance burden (for example there is no need of calculating income tax during the holiday period). This aspect tends to make this kind of incentive more attractive by many countries. For long- term investments, investors will often be required to keep records of capital expenditures and other items before and during the holiday period so as to be able to comply with the tax system following the tax holiday.

Investment tax credit on the other hand, is also of crucial importance in attracting FDI inflows. This is when the incremental tax credit which is a percentage of qualifying investment expenditure in excess of some base (typically a moving average base) aims at improving the targeting of the relief to incremental expenditures that would not have occurred in the absence of tax relief.

Another type of tax incentive commonly used in most countries is reduced taxes on dividends and interests paid abroad. This is where dividends paid by foreign investors are subjected to taxes at lower rates. It is argued that the lower the rate of taxes, the grater the incentives. Similarly other countries may allow more than full deduction for tax purposes of qualifying expenses. For instance in Tanzania, expenses on R&D is allowed fully under section 16 (2) (m) for Income Tax purposes[7]. Moreover both prospecting and development capital expenditure is allowed fully as a deduction in computation of the taxable profits in respect of people engaged in mining operations.

Zero rating or reduced tariffs is as well of crucial importance in attracting FDI inflows. Countries may reduce or eliminate tariffs on imported capital equipment and spare parts for qualifying investment projects. This has the effect of reducing the cost of investment. To encourage exports and reduce the balance of payment deficits, in countries like Tanzania all exports are zero rated[8]. In addition to the aforesaid

[5] *See Asit Advisory Studies UNCTAD 2000*

[6] *See VAT ACT, 1997 1st Schedule*

[7] *See The Income Tax Act 1973*

[8] *See VAT ACT, 1997 1st Schedule*

incentives, countries may use preferential treatment of long term capital gains in attracting FDI. This is when countries accord preferential tax treatment for appreciation in value of capital (assets) held by the enterprises if capital (assets) is held over a fixed period of time. Preferential tax treatment of long term capital gains normally intend to encourage investors to retain funds for longer periods.

The main categories of tax incentives, their objectives and rationale can be categorized and summarized as shown in table 1.

## GENERAL OVERVIEW OF THE TANZANIAN TAX STRUCTURE

Individuals and companies in Tanzania are charged income taxation in accordance to Income tax Act, 1973 which is administered by the Commissioner for Income Tax. Companies are required to pay corporate tax at the rate of 30% of the net taxable profits. They as well be subjected to other withholding taxes such as on dividends (15%), interests (15%), Management and professional fees (20%). On the other hand, technical services and management fees to mining sector (3%) or (20%) and branch profit remittance (20%).

The country charges indirect taxes that are levied and payable by individuals and/or companies. These are VAT (20), housing levy (4%) of payroll, stamp duty on sales (1.2%), transport withholding tax (2%), road and motor vehicle registration taxes at various rates. There are also airport and seaport departure charges and customs and excise duties at various rates.

In Tanzania, resident persons[9] are liable to income taxation on their world wide income (subject to double taxation agreement treaties),[10] whereas non residents only suffer income taxation in respect of such part of their total income which is said to have accrued in or derived from the United Republic. Moreover, for income tax purposes sources of income include employment or service rendered, business, investment, right for use or occupation of the property, dividends, interests, alimony, and any other income deemed to be income for income tax purposes. Appendix I provide a summary of different types of taxes and the rates applicable for both residents and non resident individuals and corporations for the period under review. For Income Tax purposes the rates were those applicable before the introduction of The Income Tax Act 2004 that became operational in 1st of July 2004.

### Major Incentives Offered in the Tanzanian Tax Structure

Compensation to investors and reward for their entrepreneurship, matching with the changing needs of the country, channeling of investments in the direction most needed for economic development and to ensure growth with social equity have been cited to be the major intention for granting tax incentives in the country. All these measures are taken by the government so as to ensure that Tanzania becomes a good destination for investors throughout the world. Tax incentives include tax relief and concenssional tax rates that can be accessed by investors via different taxation statutes. These incentives mainly are geared towards lead and priority sectors. The following are major incentives offered by the country.

Under the income Tax Act, 1973, there are maximum corporate tax rate of 30% on net taxable profits both for residents and non residents, withholding tax of 10% on dividends whereas interest on loans the rate is 0%. Moreover, the act provides for 50% write off of any capital expenditure incurred during the production of income in such year of income.

[9] A person for taxation purposes can be an individual, a corporation, body of persons other than corporations and any other person declared as such by the minister responsible for finance.

[10] Under these treaties, relief can be granted as a tax credit or total exemption in respect of the income which has already suffered tax in foreign jurisdiction.

**Table 1:** *Main Categories of Tax Incentives*

| *Objectives* | *Rationale* | *Incentives offered* |
|---|---|---|
| Performance enhancement: Export promotion | Economies of scale in exporting, country image building, differences between the actual exchange rate and the equilibrium exchange rate | Exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process; exemption from export duties; preferential treatment of income from exports, income tax reduction for foreign exchange earnings; tax credits for domestic sales in return for export performance; duty drawbacks, tax credits for duties paid on imported materials; income tax credits on net local content in exports ; deduction of overseas expenditure and capital allowance for export industries; income tax reduction or credits for net value added,. |
| Technology transfer | Spillover effects, risk aversion | Accelerated depreciation on machinery; income tax reduction /tax holiday; investment and reinvestment allowances; allowances for skills training; reduction in tax for royalties/dividends. |
| Performance enhancement: Employment/training | Imperfections in the Labour market such as a high minimum wage; spillover effects. | Tax holidays; allowances for job training expenses; deductions based on total number of employees; reduction in social security payments. |
| Performance enhancement: Domestic value addition | Problems of supplier development, spillover effects to downstream industries | Tax holidays; reduction from standard rate of income tax; loss carry forward and carry back for income tax purpose; deductions in income tax based on marketing and promotion; reductions in income tax based on total sales. |
| Sectoral investment | Spillover effects, industrial strategy and policy, national security | Exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process; accelerated depreciation on machinery; income tax reduction/tax holiday; investment and reinvestment allowances ; allowances for skills training; loss carry forward and carry back for income tax purpose; preferential treatment of capital gains. |
| Regional incentives | Shared infrastructure; equity considerations | Same as above. |

***Source:*** UNCTAD.

Furthermore, allowance is granted at the rate of 37.5%, 25% and 12.5% for the following years depending upon the classification of the machinery under consideration. The Act also allows the carry forward of deficits incurred during the year of income in ascertaining the gains or profits chargeable to tax. However such deficit is allowed only during the following year of income.Similarly, under The Customs Tariff Act, 1976, importation of capital goods for investment in the specified priority and lead

sectors are charged import duties not exceeding 5%. Moreover, importation of capital goods for investment in sectors of economic infrastructure (roads, bridges, railways, airports, installation of electricity, telecommunication, water services as well as export processing zones) are charged import duty of 0% (zero rate).

On the other hand, The Value Added Tax Act, 1997, provide for incentive in respect of value added tax on capital goods imported, purchased, or received for use in investment which is charged at the standard rate of 20% but differed up to the date of commercial production of goods and services. Similarly, the importation by licensed drilling, mining exploration or prospecting company of equipment to be used solely for drilling, mining, exploration or prospecting activities are not subjected to VAT.[11] Similarly, the supply of raw and packing materials to a registered manufacturer of pharmaceutical products are not subjected to VAT.

Apart from those incentives, The Tanzania Investment Act offers a five years tax holidays to investors holding certificate of incentives offered by the TIC. The TIC certificate guarantees investors business against nationalization or expropriation by the government. In the unlikely occasion that the company has to be acquired by the government, adequate provisions are there to ensure that there will be prompt of fair and adequate compensation and access to the court of arbitration to determine the investor interest and the amount of compensation. It is interesting to note here that the certificate of incentive enable the investor automatic immigrant quota up to five persons during the start up period and additional immigrant quotas can be granted whenever there will be a need and upon request being submitted to the Tanzania Investment Centre.

## CONCLUSION

Assessing the relative advantages and disadvantages of tax incentives is a complicated and controversial issue. The main difficult in assessing their benefits is in determining whether the incremental investment is in deed a result of tax incentives as incentives may not be a prime determinant of investment decisions. If investment is in fact a result of incentives, difficulties arise in qualifying the positive effects like technology transfer, creation of employment and possible negative effects such as economical distortions or potential for corruption. Nonetheless, in spite of these problems, assessment of incentives is useful, even necessary exercise. If nothing else, the assessment may place bounds on the extent of the incentive.

Mugoya (2003) pointed out the dangers of pursuing non-revenue, social economic goals through the fine- tuning of tax policy arguing that the subjectivity in deciding which sub-sector should be treated preferentially, complication in tax administration and narrowing the tax base may lead to tax evasion, corruption and possibly non compliance.

However, Mnyelle (1998), argues that very often than not, LDC's governments had chosen to participate in a joint venture as a sign of goodwill to attract FDI inflows in the wake of nationalization movement. Connected with this has been the issue of tax holidays as incentives to investors in a joint venture. Also the governments could be asked to guarantee the loans which are provided to the joint ventures. It is argued that these incentives hardly attract FDI. This is so because if the resources available could enable transnational corporations to profitably operate they could always establish a wholly owned enterprise regardless of whether there are incentives or not.

Issues like the size of the local market, along with its potential growth, presence of natural resources, historical / cultural links with the host country, political stabilities as well as privatization programs are of considerable importance to the developed countries in deciding which country

[11] See VAT Act, 1997 paragraph 8&9 of the 3rd Schedule

to invest. These factors not only dictate the direction of investments but also the mode of entry. For example most countries in Southern Africa, Greenfield type of investment is the most favoured mode of entry. However, joint ventures are also common and there are also some indication of moves toward mergers and acquisitions.

Apart from that there are some investment risks in most of African countries which again may have a significant impact on the directions of FDI inflows. These may include regulatory and legal uncertainty, unstable macro economic environment, HIV and AIDS, political instability, corruption, crime war and repatriation of profits.

It is from these issues that necessary steps and measures should be taken by the government towards economic growth so as to increase the size of the local market. Where the size of domestic market remains small, only a limited number of foreign investors are likely to enter. Furthermore, the functioning and sustainable free trade area needs to be implemented. As a consequence, this is more likely to offer the economies of scale required for the investment to be profitable and thus should encourage more FDI into the country.

APPENDIX I: *Summary of Tax Structure in Tanzania*

| S/N | Type of a Tax | Category of a taxpayer | Category of a taxpayer |
|---|---|---|---|
| | | *Resident* | *Non resident* |
| 1 | Corporate Tax | | |
| 2 | Shipping Tax | N/A | 30% based on 6.5% of the gross export value |
| 3 | Administration tax rate | | |
| 4 | Withholding tax rate on | | |
| | i) Dividends (including branch dividends) | 10% | 10% |
| | ii) Dividends (DSE registered companies) | | |
| | iii) Interest (other than foreign loans) | 5% | N/A |
| | iv) Interest on foreign loans | | |
| | v) Royalties | 15% | 1.5% |
| | vi) Director's fees (Non full time directors) | Exempted | Exempted |
| | vii) Management/Professional fees | N/A | 20% |
| | viii) Technical services (mining) | 10% | 10% |
| | ix) Transport (Not applicable to TIN registered traders) | N/A | 20% |
| | x) Rental income (in excess of 500,000/= p.a.) | N/A | 3% |
| | xi) Rental premium or like consideration for use or occupation of property | 4% | 4% |
| | xii) Goods and services (not applicable to TIN registered traders | 15% | N/A |
| | xiii) Insurance commission | 7.5% | N/A |
| | xiv) Business insurance claim | 30% | N/A |
| | xv) Pension and retirement annuity | N/A | 15% |
| | xvi) Management fee (mining) where it does not exceed 2% of the claimed deductions | N/A | 3% |
| 5 | Capital gains tax : 10% of the gain | | |

6. Individual income tax Non taxable threshold is 600,000/= p.a
7. Individual Rates of taxes

| | Monthly income | Tax rate |
|---|---|---|
| | Up to 50,000/=<br>50,000/=-180,000/=<br>180,000/= - 360,000/=<br>360,000/= - 540,000/=<br>Over 540,000/= | NIL<br>18.5% of the amount in excess of 50,000/=<br>24,050/= plus20% of the amount in excess of 180,000/=<br>60,050/= plus 25% of the amount in excess of 360,000/=<br>105,000/= plus 30% of the amount in excess of 540,000/= |
| 8 | Presumptive tax bands | |
| | Annual Turnover | Income Tax Payable |
| | 0 to 3m/=<br>3m/= to 7m/=<br>7m/= to 14m/=<br>14m/= to 20m/= | 20,000/=<br>50,000/=<br>165,000/=<br>385,000/= |

9. Skills and development levy 6% of the monthly gross emoluments

10. Insurance relief
    The amount of the relief is the monthly insurance premium paid or 400/= whichever is the lesser amount.
11. Housing allowance
    Housing allowance not exceeding 15% of the basic salary is not taxable
12. Capital deductions:

*Wear and tear*

| | |
|---|---|
| Class I | 37.5% |
| Class II | 25% |
| Class III | 12.5% |
| Farm works | 20% |
| Hotels and industrial buildings | 5% |
| Ships 1st year | 40% |
| Mining capital expenditure 1st year | 100% |
| Investment deductions 1st year | 20% |

Note: capital expenditure deduction for the first year for all classes of assets is 50%

**Indirect Taxes**

13. Value Added tax - 20%
14. Stamp Duty:
    Duty rates:
    I) Composition agreement 1.2%
    II) Others 4%
    III) Legal and commercial instruments: the duty is chargeable at specific rates

15 *Import Duty*

| Duty rates | Items |
|---|---|
| 0% | Agricultural tractors, inputs for agriculture, fishing, livestock, pharmaceuticals, raw materials, capital goods, replacement parts, computers and mobile phone handsets and unassembled chassis of buses fitted with engines |
| 10% | Semi-processed inputs, industrial spear parts etc |
| 15% | Fully processed inputs and motor vehicles spear parts, lubricating greases pen nibs etc |
| 25% | Final consumer goods |

Pre- shipment inspection (PSI) on commercial imports
With an exception of zero rated raw materials, it it mandatory for all imports with FOB value of USD 5,000. All imports subjected to PSI are levied a fee of 1.2%

16 *Excise Duty*

Specific rates are on wine, spirits, beer, soft drinks, cigarettes, tobacco and petroleum products
Ad-valorem rates are: 5%, 10% and 30%.

17 *Fuel Levy:* Shs. 90/= per litter of petrol or diesel

18 *Airport service charges*

| | |
|---|---|
| International travel | USD 30 |
| Local travel | Shs. 5.000/- |

19 *Port service charges*

| | |
|---|---|
| Resident traveler | Shs. 500/- |
| Non resident traveler | USD 5.00 |

20 *Motor vehicle registration tax*

| | |
|---|---|
| Motor vehicle registration fees | Shs. 90,000/- |
| Motorcycle registration fees | Shs. 27,000/- |
| Annual fee | Shs. 10,000/- |

21 Motor vehicle transfer tax

| | |
|---|---|
| Motor vehicle transfer fee | Shs. 50,000/- |
| Motor cycle transfer fee | Shs. 15,000/- |
| Alteration fee | Shs. 5,000/- |

22 Motor vehicle driving licence
Licence fee Shs. 10,000/- renewable after every three years.
Provisional licence fee Shs. 5,000/- renewable after every three months

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