Improving the cost-effectiveness of Rwanda’s tax incentives

**In brief:**

- Over the years, Rwanda has deployed a menu of tax incentives to attract investors. In 2015, total tax incentives amounted to about 0.9% of gross domestic product (GDP). A transparent and targeted strategy for giving out tax incentives is critical to ensure that they do not erode the domestic tax base.

- This study finds that Rwanda’s tax incentives are not a cost-effective tool to create jobs, induce investment, or to raise exports because they are not efficiently targeted.

- Only 11% of tax incentive expenditure goes to firms whose investment decisions are more likely to be affected by incentives - covering only 3% of firms. Wholesale and retail, a non-strategic sector for government, receives about the same amount of support as the manufacturing sector.

- To ensure cost-effectiveness, Rwanda’s tax incentives need to be time-bound, transparent, and effectively targeted to export-oriented foreign direct investment (FDI) and employment-intensive firms as well as firms that are essential to strengthening domestic value chains.

- The study also recommends a shift to a tax credit system.
Overview of the research: Calculating the costs of Rwanda’s tax incentives

To calculate the total annual cost of Rwanda’s tax incentives, the study looks at all tax incentives offered to a subset of taxpayers, which deviate from regional tax conventions and benchmarks, with the goal of improving economic outcomes. Under this definition, Rwanda has five categories of tax incentives:

- Investment-related customs duty exemptions,
- corporate income tax (CIT) deductions (investment allowance),
- CIT tax rate discounts,
- CIT tax exemptions, and
- CIT tax holidays.

The study uses these categories together with the revenue gain method (Baar and Chandler, 2017) to calculate the cost of tax incentives - the difference between the estimated revenue raised by the current tax system and the hypothetical case in which the individual tax incentive is eliminated.

Figure 1 shows the total cost of tax incentives by type of incentive. Rwanda’s estimated tax incentives are about 0.9% of GDP, which represents 3.4% of direct government spending and 5.6% of all tax revenue collected. In absolute values, this is between Rwandan franc (Rwf) 40 - 52 billion every year, between 2012 and 2016. Custom duty exemptions represent the highest share of total cost and benefit the largest number of firms. Exemptions also go more towards agro-processing and manufacturing than other sectors.

The study also provides a sectoral breakdown of costs: First, only a small number of firms receive tax incentives - about 1%. One of the main reasons for this is the high eligibility threshold for tax incentives, which makes it difficult for small firms to benefit. It is interesting to note that in the manufacturing sector the share of firms receiving tax incentives is five times the share of total firms that benefit from tax incentives.

Beneficiary firms tend to be larger, but after the revised investment code, smaller firms are increasingly eligible for tax incentives, meaning they might increasingly benefit from tax incentives in the future. Manufacturing has the largest amount of revenue forgone (34%) followed by wholesale (29%). By origin, FDI firms receive 30% of all tax incentives.
Findings: The Effectiveness of Rwanda’s tax incentives

To estimate the effectiveness of Rwanda’s tax incentives, the study conducts a dynamic micro-simulation and uses a return-on-equity (ROE) methodology to analyse how tax incentives have affected the after-tax profits of firms and their overall long-term returns to investment. The analysis compares a firm’s ROE with and without tax incentives to determine whether tax incentives were effective or not.

Based on this analysis, the paper comes up with four categories of firm effects with their corresponding share of expenditure and share of firms affected. The results are presented in Table 1, below.

Table 1: The effectiveness of Rwanda’s tax incentives

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<thead>
<tr>
<th>Type of effect</th>
<th>Share of expenditure on tax incentives</th>
<th>Share of firms</th>
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<tbody>
<tr>
<td>1. Unviable investments:</td>
<td>21%</td>
<td>7%</td>
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<tr>
<td>Benefits to investors whose returns are very low, even with incentives. These investments are not viable with or without incentives, and thus incentives are unlikely to generate new investment.</td>
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<td>2. Redundant incentives:</td>
<td>55%</td>
<td>44%</td>
</tr>
<tr>
<td>Benefits to investors with high returns on investment, even without incentives. While there may be investors requiring very high returns to start investing, it is generally less likely that such incentives had any effect on investment. Rather, it likely represents a windfall to firms that would have invested anyway.</td>
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<td>3. No effect:</td>
<td>14%</td>
<td>46%</td>
</tr>
<tr>
<td>Investors only benefit a small amount from incentives. There is an improvement in profitability, and so tax incentives would not affect their investment decisions.</td>
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<td>4. Marginal firms:</td>
<td>11%</td>
<td>3%</td>
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<tr>
<td>Benefits go to firms whose investment decision is more likely to have been affected by incentives, which amounts to only 3% of firms. These firms shifted from generally unprofitable to profitable as a result of receiving tax incentives.</td>
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The study also provides results based on three types of FDI (Dunning et al., 1993): Efficiency-seeking, market-seeking, and natural-resource seeking FDI. Tax incentives were not important for the investments returns of efficiency-seeking or natural resource seeking FDI. For market seeking FDI, five market seeking firms, representing 1% of all tax incentives, were found to be “marginal firms”.

Findings also vary by sector. Manufacturing, wholesale, and retail have high rates of marginal firm with most marginal firms in the manufacturing sector. A look at Rwanda’s other priority sectors shows that agriculture, agro-processing, and tourism did not have similar benefits from tax incentives as did manufacturing and wholesale/retail. This is because these sectors receive less incentives than manufacturing and wholesale/retail. The study also found that these sectors were generally unprofitable.
The final analysis of the study looked at the effect of tax incentives on investments and exports as well as job creation. The idea is that tax incentives provide firms with the support they need to operate in Rwanda and that this support allows them to invest and export more than if the firm had not received the support. The results are not very encouraging:

- For every 1 RwF granted in tax incentives, firms are found to invest an additional 1.3 RwF.
- Tax incentives are relatively ineffective in inducing exports: 1 RwF spent on tax incentives generates only 0.2 RwF in exports, about a sixth of the benefit to investments.
- The average tax incentive cost of a job created per a year is high: RwF 4.2 million - but this cost varies considerably by sector.
- One of the highest job costs is in the transport sector: It costs RwF 33.6 million to create one job in a year.
- This is about twice the cost per job of the agriculture and wholesale/retail sectors: The cost for creating one job a year is RwF 15.8 million and RwF 15.6 million respectively.
- Job costs per year are lower in the manufacturing sector: RwF 10 million.

**Policy recommendations**

- **Target tax incentives at export-oriented FDI, employment-intensive firms, and firms that are essential to strengthening domestic value chains.**

A key step in improving the cost-effectiveness of Rwanda’s tax incentives is to identify the strategic objectives for offering incentives. Based on Rwanda’s economic ambitions, as outlined in its investment policy, export-oriented growth, the creation of decent jobs, and boosting domestic firm productivity are essential for Rwanda’s economic growth. Thus, any tax incentive programme must be designed for meeting these goals.

- **Explore removing all tax holidays and CIT rate reductions and shifting towards a well-defined system of tax credits.**

To better meet the target of stimulating growth in new sectors and promoting exports, it can be helpful to move incentives from profit-based incentives (e.g. tax holidays and preferential rates) and towards cost-based incentives (such as customs duty exemptions and tax credits). Profit based tax incentives are targeted towards guaranteeing firms a level of profit without necessarily targeting productivity increases and job creation. A tax credit system could help Rwanda better link tax to desired economic outcomes. The amount of tax credits offered could be pre-defined in ‘bands’ related to the expected future benefits of attracting such an investor.

- **Target incentives to those investors that are most responsive to them.**

Rwanda has aimed to restrict tax incentives mainly to large investors in priority sectors and offering more generous incentives to attract large, foreign pioneers (though the distinction between domestic and export-oriented motivations is often not made). Yet, this study found that there are important differences between firms that aim to receive incentives and those that actually receive them.

- **Customs duty exemptions should better align with Rwanda’s priority sectors by exempting productive inputs and excluding consumer goods.**
While some manufacturing firms benefit from lower customs duty on inputs, many smaller firms in this sector are still forced to pay high import duties for such goods when misclassified as consumer products under the common external tariff. We also find a large share of incentives currently going to non-productive sectors (wholesale and retail). Shifting benefits across sectors will increase the productive benefits of customs duty exemption at no extra revenue cost.

- **CIT tax incentives should have lower eligibility thresholds and become more performance-based.**

Few firms benefit from CIT tax incentives due to high eligibility thresholds (e.g. minimum investments). While this kept cost low, it also reduced the potential of tax incentives to affect economic performance. Rwanda should lower the eligibility thresholds to include more medium-sized firms.

To limit their overall revenue costs, all such incentives should become time-bound and performance-based (e.g. restricted to five years and linked to targets related to exports or employment). This will also allow the Government of Rwanda to calibrate incentives according to firms’ willingness to invest, to have some indication of the revenue foregone in the medium-term and to cut off losses in terms of revenue foregone from non-profitable firms.

- **To improve FDI attraction, tax incentives should be embedded within a broader FDI strategy to improve Rwanda’s value proposition for efficiency seeking investors.**

- **Ensure suitable take-up of incentives through transparent and rule-bound administration and regular monitoring.**

To improve the tax predictability for investors, Rwanda should develop publicly available briefing notes on all tax incentives and customs duty exemptions, with clear explanations around eligibility criteria and application processes. This will help give clarity around the types of incentives for which firms are eligible and explain how to apply for them.

The Government should also provide investors with greater clarity on the types of ‘deals’ the Rwanda Development Board (RDB) can offer. This will assist in moderating investor expectations on the kind of support they are entitled to and help prevent investor disappointment, thereby avoiding reputational damage to Rwanda’s regulatory environment. Lastly, there needs to be an annual cost-benefit analysis of Rwanda’s tax incentives to identify how best to further increase their effectiveness.

- **Tax incentives should contain sunset provisions that phase out benefits after some predetermined time, after which companies and their activities become competitive.**

- **The implementing agency should carefully monitor incentives to ensure that beneficiaries are delivering on promised performance.**