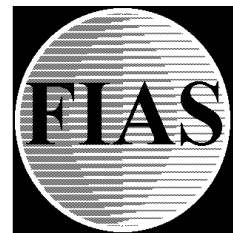


Sector Study of the Effective Tax Burden

Rwanda

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SUMMARY OF ACRONYMS

CIT	Corporate Income Tax
DFID	Department for International Development
FDI	Foreign Direct Investment
GOR	Government of Rwanda
GDP	Gross Domestic Product
M&E	Machinery and Equipment
METR	Marginal Effective Tax Rate
MSSE	Micro and Small Scale Enterprises
VAT	Value Added Tax
RA	Revenue Authority
RIEPA	Rwanda Investment and Export Promotion Agency
RRA	Rwanda Revenue Authority

This report forms part of a multi-country study of African revenue authorities FIAS are undertaking in collaboration with the United Kingdom Department for International Development (DFID). The purpose of the study series is to determine whether the tax policy and tax administration regimes are conducive to economic growth. A key focus is on the opportunities created by bringing informal firms into the tax net and appropriate tax policies for small enterprises. FIAS undertook a pilot study of Zambia, published in December 2004.¹

On behalf of the Government of Rwanda, the Ministry of Finance, in conjunction with the Rwanda Revenue Authority, requested that FIAS conduct a similar study of the effective tax burden on five key sectors in economy. The purpose was to investigate whether these sectors are competitive domestically and internationally, as regards the impact of the tax regime. This study provides the government with information it seeks through use of marginal effective tax rate calculations carried out in each of the identified sectors, and through qualitative analysis about the appropriateness of the tax /incentive scheme undertaken by sector experts. It also offers cross-country analysis allowing the assessment of international competitiveness. A third component built into this study is a capacity building exercise, with the group of international consultants tasked to work closely with a Ministry of Finance and Rwanda Revenue Authority counterpart group to transfer the knowledge and methodology underlying such an analysis.

¹ The Swedish Agency for International Development co-funded the Zambia study.

Summary of Key Issues and Recommendations

Issues	Recommendations
<p>General Economy The new tax code and existing VAT code are broadly appropriate and conducive to growth of the five sectors. Tax issues are second order.</p>	<ul style="list-style-type: none"> • Avoid significant changes to the tax code, which would create uncertainty in the private sector. • Review the necessity of fiscal incentives for large businesses and eliminate as many as possible.
<p>Small businesses (METR 12-51%) Optional 4% turnover tax in lieu of CIT for businesses with a turnover < RWF20 million. Firms of any size may register for VAT. Wide variation in METRs shows that whether small firms chose the presumptive regime, and/or chose to register for VAT is critical.</p>	<ul style="list-style-type: none"> • Reduce turnover tax to 3% to encourage more small firms into the tax net. • Revise VAT reporting requirements from monthly to quarterly returns. • Enhance role of the RRA to include outreach and education for MSSEs. • Simplify standard tax regime to help small businesses.
<p>Agriculture Sector (METR 7%) Largely informal and outside the tax net (bar coffee and tea farmers). Do pay some municipal levies. Benefit from significant tax concessions, including no CIT below RWF 12m turnover and VAT exempt inputs and outputs.</p>	<ul style="list-style-type: none"> • Investigate ways to bring farmers into the tax net. • Halve the turnover threshold for exempting agricultural income, in order to improve integration between personal income tax and taxation of small business. • Similarly, the VAT exempt status of the sector is overly generous.
<p>Manufacturing Sector (METR 17%) Fragile sector mostly focused on import substitution. Heavy import dependency (for inputs and capital), makes the land locked nature of Rwanda a particular hurdle. Treatment of 'reverse charge VAT' is currently a contentious issue. Significant incentives for investors registered with the RIEPA.</p>	<ul style="list-style-type: none"> • Further simplification of the re-fund mechanism for reverse charge VAT on imported services • Reform the Magerwa charge to separate out the import tariff and warehousing fee component. The warehousing fee should be based on volume rather than value. • Review of tax incentives: remove tax holidays; make allowances universal; ensure allowances are not overly generous.
<p>Tourism (METR 14%) Small but growing sector. Prospects for growth outside of the gorilla safari sector appear minimal. Much misunderstanding of how VAT works, which contributes to an unnecessary tax burden in many cases.</p>	<ul style="list-style-type: none"> • Hold VAT education and interpretation workshops. • Evenly apply sector incentives to firms of all sizes. • Remove visa requirements in major source markets such as Germany, France, etc and reduce visa costs to \$30. • All legitimate businesses expenses (inc. fuel and telephone) should deductible for income tax purposes. • Impose VAT on gorilla permits issued by the ORTPN.
<p>Financial Sector (METR 38%) Weak and fragile sector with only six licensed banks but over 100 micro-finance institutions – many unregistered. Pensions have recently moved to the E/E/T system of tax. Some banking and insurance activities are VAT exempt.</p>	<ul style="list-style-type: none"> • Reform the tax treatment of leasing transactions. • Carefully evaluate the impact of the 0% CIT tax on micro-finance institutions. • Allow the expensing of debts which are extremely unlikely be collected, without the need for formal bankruptcy procedures
<p>Mining Sector (METR 15%) Small sector, but growing. Dominated by artisan miners, often paying only municipal levies. Some generous incentives on capital equipment import duties and rates of depreciation.</p>	<ul style="list-style-type: none"> • Review and clearly regulate municipal based taxes. • Formalize small-scale miners through enforcing the small business presumptive tax. • Apply tax code evenly across the industry to firms of all sizes.

EXECUTIVE SUMMARY

Background

This FIAS/DFID report forms part of a series of studies designed to improve understanding of the impact of tax policy, and in particular its administration, on the business climate in southern Africa.

The success over the last decade in establishing semi-autonomous revenue authorities in various countries in the region has achieved increased tax collection. There has been little focus on the possible business and growth impacts of revenue targets and internal performance incentives.

The study uses both quantitative and qualitative techniques to address these concerns. The quantitative component uses Marginal Effective Tax Rate (METR) techniques to investigate how the tax code, as defined in legislation, benefits certain sectors over others. The qualitative component addresses in more detail how tax administration works in practice, including a political economy analysis of the RRA as an institution.

Context of the Study

Since 1994, the Government has embarked on an ambitious agenda of structural reforms to establish an environment conducive to private sector investment. The Government is committed to pursuing the reform agenda and removing barriers to entry or growth of private businesses, to overcome a perception of Rwanda as a high risk market, unattractive to existing and potential investors. To this end, the Government of Rwanda is committed to address these issues, through streamlining the business environment, lowering the cost of doing business and facilitating the emergence of a strong local business community by providing financial and non-financial services.

Rwanda has achieved robust growth over the last ten years. Although growth has slowed in recent years, it remains well above the average for sub-Saharan Africa. While an increasing number of countries, including some regional competitors, have experienced increases in Foreign Direct Investment (FDI) and the share of investment in the form of FDI over the past decade, Rwanda has not.

This study gives priority to five sectors, chosen because of important contribution to current output and production and for their potential for growth and new investment: agriculture, mining, manufacturing, financial services and tourism.

Notable is the stagnation in the share of different sectors. There has been no significant shift in the economic contribution of the various sectors.

Although the government has undertaken a range of policy reforms in the past years, total investment remains low. Economic reforms that have taken place at the macroeconomic level in Rwanda do not appear to have altered the perceptions of the business community that the investment climate is generally poor.

The World Bank's 'Doing Business' project provides a good starting point for assessing Rwanda's investment climate. Rwanda emerged well from the most recent Doing Business survey, and ranked as one of Africa's top performers. Even so, Rwanda's overall place was only 139th out of 155.

Tax policy in Rwanda

At the time of this study, tax policy in Rwanda was undergoing some change. A new tax code for direct taxation, a new investment promotion code and a new schedule for investments under the customs legislation had been drafted. It was the intention of the Government of Rwanda to publish ('gazette') these three pieces of legislation together in 2006, at which time they would become law.

This study takes as its starting point the assumption that the three new tax codes will be duly gazetted and implemented. Much of this new legislation will amend and replace existing tax codes.

Tax revenue performance

From a macroeconomic perspective, tax policy in Rwanda has been increasingly effective at raising revenues, as measured by tax/GDP ratios. The current tax/GDP is around 14 percent of GDP, up from 9.2 percent in 1996.

Total central government revenues in 2004 amounted to 147.1 billion RWF (approximately US\$277M) 91 percent of which was collected through taxation. External donor financing plays a significant role in Rwanda's budget. In 2004 donor contributions (including assistance under the Heavily Indebted Poor Country Initiative) amounted to 126.7 billion RWF.

Main findings of the report

The results of this study provide input into the government's tax policy discussions; it will allow the authorities to assess the relative tax and incentive packages in each of the key sectors of the economy and to determine the

effectiveness of each package to investment and private sector development in the country as a whole.

Sector analysis and recommendations

Agriculture

Agriculture is the largest sector of the economy and accounts for 41 percent of GDP. The majority of farms are informal, subsistence based and operate outside of the tax net, either because produce is not sold commercially or because the size of the business is so small.

Farms that do operate as a business, mostly on a sole proprietor basis, receive favorable tax treatment. The first 12 million RWF of farming income per annum is exempt from personal tax. All farming outputs and inputs (including equipment) are VAT exempt. The same is not true however, for value added processing of agricultural products.

Agriculture is one of the ‘priority sectors’ identified by Rwanda Investment and Export Promotion Agency. As such, it qualifies for a 50 percent investment allowance under the new tax code. Further, qualified and approved investors under the new investment code will be able to import agricultural equipment duty free.

The overall aggregate METR on capital deployed in agriculture is only 7%, which is the lowest of all the sectors. The principal reason is that a large share of capital used for farming is in land and inventory, which benefit significantly from a tax subsidy during periods of high inflation. The VAT exempt status of inputs and outputs also contributes to the low METR for agriculture.

If the 50 percent Investment Credit Allowance is incorporated from year one of operation, the METR falls to -10 percent. As agriculture’s biggest investment is land, which does not depreciate, the benefit of the investment allowance for depreciable assets is felt most acutely in other sectors.

Recommendations

- The turnover threshold for exempting income from farming and agricultural activities should be halved in order to improve integration between personal income tax and taxation of small business including small agricultural firms.
- Similarly, the VAT exempt status of the sector is overly generous, and

merits review in the medium term.

Mining Sector

Although the mining sector in Rwanda is small (contributing less than 1 percent of GDP) it contributes significantly to exports. Minerals contributed 29.7 percent of all exports in 2004, second only to coffee.

The mining industry in Rwanda is dominated by small scale artisan miners, most of which do not pay any corporate tax. Small scale artisan miners sell their minerals to co-operatives and other large mining organizations who then market and export the minerals, either before or after processing.

Artisan miners appear to be paying several local taxes, including municipal mining licenses and a per hectare local mining land tax. In addition, they appear to be paying a further local municipality tax based on the amount of natural resources produced, which in some cases is considerable, and has a questionable basis in law.

Withholding tax and reverse charge VAT associated with the importation of overseas based services has a large impact on the mining industry, especially in the case where local specialized skills are not available, such as geologists and other exploration specialists.

VAT has a very limited effect on the mining sector in Rwanda as most minerals which are mined, are exported, and therefore are zero rated for VAT.

The overall weighted average METR on capital in the mining sector is 15% without the investment allowance. This reflects the fact that machinery and equipment used for mining generally have a longer useful life compared to those used by other sectors. The economic depreciation rate, or replacement cost, for M&E used for mining is low when compared to M&E used by other sectors. For the given tax M&E for mining, which contributes to the lower METR on capital invested in mining sector. Note the METR in the mining sector, in order to ensure consistency with studies to be conducted in other regional countries, used inputs, assumptions and weightings based on international best practice. The resulting effect is that the METR is applicable mainly to large scale mining operations that tend to use highly mechanized and capital intensive means of extracting mineral as opposed to very labor intensive small scale miners which are labor intensive.

Recommendations

- Review municipal-based fees and licenses system to ensure transparency and certainty, i.e., to eliminate discretion

- Formalize artisan and small-scale miners through enforcing the small business presumptive tax
- Apply tax instruments uniformly, regardless of size of mining operation.
- Further simplification of the re-fund mechanism for reverse charge VAT on imported services.

Manufacturing

Rwanda's manufacturing sector accounts for 8 percent of GDP and is dominated by the production of import substitutes for internal consumption. The fragile domestic manufacturing sector continues to face strong regional competition following accession to COMESA in 1994, erratic power supply, and high transport costs. As a result, manufacturing's contribution to GDP has fallen between 1999 and 2004.

While the manufacturing sector is subject to the standard tax regime, the **capital-intensive** nature of the sector and heavy **import dependency** makes taxation (and import duties particularly) a significant burden for firms.

Manufacturing is particularly disadvantaged by the high cost of transport for imports, which are estimated to be 30-50 percent higher in landlocked countries. The 4 percent Magerwa (Rwanda Warehousing Company) handling fee on imports is a serious concern to the manufacturing sector as it adds to the already high import costs. Of this, 3 percentages accrues to the revenue authorities, and 1 percentage to Magerwa. The handling charges are based on import value rather than volume and are viewed as a hidden tariff.

The implementation of the “reverse charge” VAT for imports of services, such as transportation or management services, has faced some problems. The government is addressing the above by issuing a ruling that will exempt VAT on imports of international services that can be proved to not be available locally. This is sub-optimal since the burden of proof for a negative lies with the importer.

Under the new law, registered investors operating in a Free Economic Zone are entitled to tax holidays. International experience and research suggests that relative to other types of incentives, tax holidays suffer from major weaknesses.

The overall weighted METR for manufacturing is 17 percent, higher than tourism and agriculture sectors. However, the METR on buildings and machinery & equipment is higher at 22 percent, the highest amongst sectors. The primary reason for the higher METR is that depreciable assets used for manufacturing purpose wear and tear more rapidly than those used for other

business purposes. Depreciable assets also account for the majority of capital assets used in the manufacturing sector. For firms operating in the Free Economic Zone, the METR is zero.

For small manufacturers paying the 4 percent turnover tax and not registered for VAT, the METR is 49 percent, the second highest amongst sectors studied. Because of this tax burden, and a lack of knowledge of compliance requirements, small businesses face incentives to engage in tax avoidance and evasion (under-reporting of turnover). Small businesses tend not to make use of the opt-in for VAT registration, due to a lack of awareness or not being able to meet the accounting requirements – the METR would fall to 18 percent if small firms registered for VAT.

Recommendations

- Further simplification of the re-fund mechanism for reverse charge VAT on imported services
- Reform the Magerwa charge to separate out the import tariff component and the warehousing fee component. The warehousing fee should be applied according to volume rather than value.
- Review tax incentives: remove tax holidays; move to universal allowances; and ensure that allowances are not overly generous (i.e. do not produce large negative METRs).
- Review procedures for tax audits to limit time for completion of audits and charge of interest for late payment from date of completion of audit.

Tourism

The tourism industry is in the early stages of development, having to rebuild from almost zero in 1994. In 2005 tourism is estimated to contribute 3.3 percent of GDP and generate 47,999 jobs. The tourism industry is currently focused on primate tours in the Volcanoes National Park, which houses the majority of the last remaining 600 mountain gorillas in the world.

The standard VAT rate of 18 percent is applicable to most services offered in the tourism industry. In the law there is provision for exempt and zero rated items for the tourism sector. Some of these have been developed specifically for the tourism industry while others are generic, but are applicable to some of the products and services in the tourism industry.

A maximum of 30 percent of the VAT or a maximum of RWF 25,000 can be claimed back on telephone and fuel expenses. These restrictions have a significant impact on the tourism and hospitality industry which suffer from high fuel costs used with tourist vehicles, airport shuttles and generators required to run lodges and hotels during power cuts. Telephone costs are also a considerable expense, associated with overseas telephone reservations and revenue from telephone use in guest rooms.

A number of incentives are provided in the investment code. Tourism businesses benefit from zero customs and excise duties on the importation of tour operator vehicles, hotel shuttles and other specialized vehicles.

In principle the tourism sector benefits greatly from VAT concessions and reductions, however in practice this is not the case. There is a severe lack of understanding of the VAT system, especially amongst the smaller and more informal operators, resulting in a low buy-in to the system, despite a considerable amount of VAT and tax education by the RRA.

The overall weighted average METR on capital in Tourism is 14%, the second lowest among other sectors. This is mainly because the majority of depreciable assets used for tourism business are entitled to a tax depreciation allowance closely matching their economic depreciation rate. As a result, METR on depreciable assets (buildings and machinery and equipment) used by tourism sector is lower than its counterpart in other sectors. In addition the larger businesses in the tourism industry receive considerable benefits relating to accelerated depreciation of business assets and no duty on a vast amount of equipment, machinery, fixtures and fittings used in the tourism industry.

Recommendations

- Hold education and interpretation workshops between the RRA and the tourism associations.
- Evenly apply the incentives focused on the imports of tourist vehicles and equipment and machinery across the sector.
- Continue to apply the zero rating of tour packages for a limited period.
- Remove visa requirements in major source markets such as Germany, France, Italy, Netherlands, etc and reduce visa costs to \$30 to encourage tourism.

- All fuel and telephones expenses, proven to be a legitimate business expense, should be deductible for income tax purposes.
- Impose VAT on gorilla permits issued by the ORTPN.
- Investment allowance should apply to all investors irrespective of size.

Financial Sector

Rwanda has a fledgling financial sector. In all key markets (banking, pensions and insurance), there are few providers, few products and a limited customer base. However, this situation is changing and legislation and taxation reform will play an important role in driving growth in this critical sector.

There are six licensed commercial banks, a development bank and two cooperatively owned finance institutions. There are also over 100 micro-finance institutions, of which the Reserve Bank has only licensed eight. The new law provides for a corporate income tax of zero for micro-finance institutions for a period of five years. It will be interesting to evaluate whether this leads to a sustained expansion in micro loans.

Insurance companies also pay the standard rate of corporate income tax. The new law moves the treatment of pensions to an ‘E/E/T system’, where-by pension contributions (from both employers and employees) are tax exempt, pension fund returns are exempt from corporate income tax, but pension payments are taxable as personal income. This is likely to promote savings and may help to restrain wage inflation (given the myopic nature of most employees).

As personal account fees are VAT exempt, banks bear an effective sales tax burden on their inputs to this portion of their business. However, as personal account fees currently generate a small proportion of banks’ revenue, this exemption is likely to have less of an impact on the METR than with medical insurance (which is also exempt).

Leasing (operating or capital) provides a very useful way for low-income countries to increase investment. Currently, due to a lack of alternative legislation, RRA’s position is that both the interest and principal portions of capital lease payments are VAT-able. This is understandable (RRA are applying the VAT legislation as they view it) but unfortunate as it puts capital leases at a disadvantage to a similar transactions structured as a loan to purchase an asset.

Banks benefit from bad debt allowances, which are more generous than those available to other sectors. This is primarily because of the reserve requirement for the non-performing loans.

With an overall weighted average METR on capital of 38%, the financial sector bears a marginal tax burdens on capital that is highest among other sectors studied. This is mainly because of the VAT exempt status on some financial activities. Financial services are one of the few sectors not designated a ‘priority sector’ by the new investment code and so does not benefit from incentives.

Recommendations

- Change the tax treatment of leasing transactions. Specifically:
 - The VAT Act needs to state clearly that leasing is classified as other financial service products therefore exempt from the interest portion;
 - Provide guidance on VAT treatment throughout the chain – from supplier to the lessee;
 - Clarify the current tax treatment of leasing transactions. It is assumed that the lessors will be allowed to claim the capital allowances while the lessee is able to deduct the full lease rental.
 - Harmonize the application of withholding tax within the East African region so as to promote cross border leasing.
 - Allow for leased assets to qualify for incentives provided for by RIEPA in case of capital lessees.
- Carefully evaluate the impact of the 0 percent corporate income tax on micro-finance institutions.
- Allow the expensing of debts which are extremely unlikely be collected, rather than relying solely on formal bankruptcy procedures.

Small Business Sector

A recent study estimated that there are nearly 70,000 micro and small scale (MSSE) enterprises in Rwanda (defined as turnover of less than RWF 15 million per annum). However, only around 1,000 small businesses are currently registered with the tax authorities (defined as turnover less than RWF 20 million in the new law). This indicates that most small businesses are registered at the local government level, or operate outside the formal sector.

Under the small tax regime, small businesses with an expected turnover of less than RWF 20 million may opt to pay a presumptive tax of 4 percent of turnover or can opt to pay the standard corporate income tax of 30 percent. Most small businesses tend to opt for the presumptive regime. Although this simplifies tax

administration, it does not contribute to creating or strengthening a culture of compliance among small businesses. Even when informed and profitable small businesses opt for the corporate income option, in practice they may be unclear about the nature of expenses that qualify for deduction from taxable income (even though the new law lists these items).

As many small businesses in Rwanda are sole traders, they are in effect taxable under the personal income tax regime: exempt for income up to RWF 360,000, 20 percent between RWF 360,001-1,200,000, and 30 percent above RWF 1,200,001. This means that they face an effective tax rate of 0-30 percent.

While small businesses are not required to register for VAT, staying out of the VAT net may be more of a tax burden than paying the tax. Non-registration often creates breaks in the VAT chain resulting in small businesses not being able to claim back VAT on inputs. Small businesses therefore may suffer a substantive VAT burden. However, in order to enter the VAT net, to meet reporting requirements a taxpayer must submit monthly reports. This is beyond the capacity of most small businesses.

The METR analysis shows that small businesses may face a higher METR than large firms. The marginal effective tax burden on small businesses paying the turnover tax is higher than large businesses that pay corporate income tax and irrespective of whether they benefit from the 40 percent investment allowance (50 percent for priority sectors).

In addition, since many small business do not register for VAT (and hence cannot claim input tax credits), they may face a significantly higher METR than large firms with or without investment allowance – this is the case in all sectors except agriculture, where both input and output are exempt from VAT. In particular, small firms in manufacturing, mining and tourism can incur a METR more than double that for large firms. Because of the high METR, in practice, many businesses either under-report taxes or operate unregistered in the informal sector.

The simplified presumptive turnover tax, while requiring less capacity probably carries a much higher tax burden than the standard regime. Small businesses perceive the tax system as incurring high time and financial cost and thus may not see any incentive to join the tax net even if they could. Small businesses face an ‘inverse economies of scale’ impact of paperwork and procedures required for tax authorities.

Presumptive turnover tax can simplify tax administration and compliance costs and hence benefit both tax administrators and taxpayers. However, a high presumptive turnover tax may play a negative role by encouraging small firms to avoid paying the tax via under-reporting of gross revenues causing additional

revenue authority auditing. This interaction may form a vicious circle, and lead to an unhealthy tax environment that encourages expansion of the informal economy.

The Rwanda Revenue Authority has one of the most effective programs of community information dissemination in the region. However, it does not have an outreach program for small businesses with the aim of building a ‘culture’ of tax compliance. Tax compliance and recording requirements are often strong deterrents to registering a business and paying taxes. In addition, many small firms do not have enough information to be able to enter the tax net even if they had the desire and necessary skills to do so. This deficiency may be partly addressed through the launch of the joint public-private initiative of Business Development Services centers. These centers are a good venue for training on financial accounting practices, as well as facilitating the process of formalization by providing information and training on tax registration.

The most recent Doing Business report shows that Rwandan companies are required to pay 42 different taxes. Although the new tax code will reduce this figure, the RRA need to continue to work to bring down this number that will greatly help reduce informality.

Recommendations

- Continue to investigate ways to bring down the number of taxes paid and simplify the reporting mechanism for small firms. E.g. simplify standard tax regime to help small businesses.
- Consider reduction of turnover tax rate to 3 percent from 4 percent to encourage more small firms into the tax net.
- Revise VAT reporting requirements from monthly to quarterly returns.
- Review VAT penalties and interest due for late payment for small businesses.
- Enhance role of the RRA to include outreach and education for small businesses.

International Comparisons

Results suggest that METRs in Rwanda compare favorably with those of South Africa, Malawi, Tanzania and Zimbabwe. METRs in Rwanda are generally lower

than or roughly similar to those in the comparison countries, except for investment in inventories in countries with lower rates of inflation and some investments in Zimbabwe. However, METRs in Zimbabwe are relatively low (for assets other than inventories where the FIFO accounting results in taxation of inflationary gains) not because the tax system is more generous than in Rwanda but because the inflation rate is so high (over 50 percent) – not an example Rwanda would want to emulate. And, as noted above, METRs on investments in inventories in Rwanda would be reduced dramatically if firms chose the LIFO inventory accounting system. Thus, it seems that the tax component of the investment climate in Rwanda should not be a significant barrier to investment, relative to the tax systems of neighboring countries.

1. INTRODUCTION

Background

This FIAS/DFID report forms part of a series of studies designed to improve understanding of the impact of tax policy, and in particular its administration, on the business climate in southern Africa.²

The success over the last decade in establishing semi-autonomous revenue authorities (RAs) in various countries in the region has achieved increased tax collection. An unforeseen consequence of creating RAs may have been to strengthen RA incentives to maximize revenue generation while weakening the authority of ministries of finance to formulate tax policy for broader national needs - especially business development, investment and growth for sustainable poverty reduction. There has been little focus on the possible business and growth impacts of revenue targets and internal performance incentives.

This project therefore aims explicitly to develop understanding on African RAs' business impact. 'Doing Business 2006'³ showed that countries that tax highly and have complex regulations (and hence provide strong incentives to evade), generally receive lower tax revenues than countries with low rates and broader tax bases. Reflecting on examples of successful policy reform, this series of studies will suggest reforms in both tax policy and administration that may stimulate savings, investment and growth – such as through selectivity/disciplining of rents/security of rents, and tax exemptions.

The study uses both quantitative and qualitative techniques to address these concerns. The quantitative component uses Marginal Effective Tax Rate (METR) techniques to investigate how the tax code, as defined in legislation, benefits certain sectors over others. The qualitative component addresses in more detail how tax administration works in practice, including a political economy analysis of the RRA as an institution.

Tax impact on business in wider context

This study recognizes that in many cases sub-national taxation or customs may have a larger impact on businesses than national taxes. Surprisingly little

² “Tax administration *is* tax policy”, M. C. de Jantscher: Administrating the VAT: in Value Added Taxation in Developing Countries: World Bank 1990, p.179.

³ See www.doingbusiness.org, The World Bank's Doing Business database provides objective measure of business regulations and their enforcement.

information is available on what percentage and kind of taxes are being paid by what type or size of business in sub-Saharan Africa – not only at the national level (the focus of this project), but also at sub-national level and on international trade. This data is necessary for a complete picture of where the burden of taxes and compliance costs falls most heavily and what distortions to growth patterns may result. These broader issues are beyond the scope of this project, but it is hoped that they will be explored in due course, perhaps through the Investment Climate Facility for Africa currently being established.

This project appreciates that tax may be only a small part of the wider picture of what affects the incentives to invest. Other factors may include economic governance, trade tariffs, security etc.

Context of the Study

Since 1994, Rwanda has made great strides in reforming its investment climate in support of private sector development.

The Government is focused on tackling the structural problems of poverty reduction and is fully aware that strong growth, led by private sector investment, is a key to helping the Rwandese improve their living conditions and build a solid foundation to reconciliation.

To this end, the Government has (since 1994) embarked on an ambitious agenda of structural reforms to establish a conducive environment for the private sector and accelerate economic growth. Specific reforms cover the following areas: (i) the establishment of a framework of regulations and institutions favoring private sector development; (ii) trade liberalization; (iii) liberalization of domestic prices and marketing for commodities; (iv) public enterprise reform, including the privatization of about 60 state-owned companies; (v) opening up the water, energy, telecommunications and tea sectors to competition; (vi) liberalization of the exchange regime; (vii) financial sector strengthening, including the Central Bank, and improvement of the policy and social security system.

The Government is committed to pursuing the reform agenda and removing barriers to entry or growth of private businesses, to overcome a perception of Rwanda as a high risk market, unattractive to existing and potential investors, both foreign and domestic. To this end, the Government of Rwanda is committed to address these issues, through streamlining the business environment, lowering the cost of doing business and facilitating the emergence of a strong local business community by providing financial and non-financial services.

Background to the study

Growth and performance in the past

Table 1 shows that Rwanda has achieved robust growth over the last five years. Although growth has slowed more recently, it remains well above the average for sub-Saharan Africa.

Table 1: Rwanda: Economic Data 2001 - 2005

	2001	2002	2003	2004	2005
GDP at market prices (Rwf bn)	754.3	815.9	905.3	1,027.10	1,174.40
GDP (US\$ bn)	1.7	1.7	1.7	1.8	2.1
Real GDP growth (%)	6.7	9.4	3.2	4	5.2
Consumer price inflation (av; %)	3.3	2	7.5	11.9	8
Population (m)	8.4	8.6	8.8	8.9	9.1
Exports of goods fob (US\$ m)	93.3	67.2	63.1	97.3	105
Imports of goods fob (US\$ m)	245.2	233.3	244	273.1	364
Current-account balance (US\$ m)	-102.5	-126.2	-132	-52.7	-166.1
Foreign-exchange reserves excl gold (US\$ m)	212.1	243.7	214.7	314.6	357.4
Exchange rate (av) RWF:US\$	442.8	476.3	537.7	574.6	565

Source: Economist Intelligence Unit 2005

Sector contributions to growth

This study gives priority to five sectors, chosen because of their important contribution to current output and production and for their potential for growth and new investment. These are: agriculture, mining, manufacturing, tourism and financial services. Together these five sectors represent around 63 percent of total GDP.

Table 2. Rwanda: Sector contribution to total GDP, 1999-2003 (in percent of total GDP)

	1999	2000	2001	2002	2003
Primary	43.86%	45.14%	45.83%	47.96%	46.03%
-food crops	36.35%	37.85%	38.58%	41.11%	39.26%
-export crops	1.53%	1.26%	1.30%	1.25%	1.05%
-livestock	4.22%	4.24%	4.22%	3.96%	4.04%
-other	1.75%	1.81%	1.75%	1.63%	1.67%
Secondary	17.05%	16.60%	16.76%	16.54%	17.11%
-mining	0.22%	0.22%	0.21%	0.17%	0.13%

-electric, gas and water	0.31%	0.26%	0.23%	0.21%	0.20%
-manufacturing	9.44%	8.53%	8.62%	8.28%	7.79%
-construct & pub works	7.06%	7.59%	7.70%	7.90%	8.99%
Tertiary	39.13%	38.24%	37.43%	35.50%	36.87%
-commerce & tourism	9.44%	8.77%	8.62%	8.28%	8.78%
-transport & communications	6.83%	7.24%	7.27%	7.04%	6.66%
-public administration	8.40%	8.16%	7.74%	7.13%	7.78%
-services	14.46%	14.07%	13.79%	13.03%	13.65%

Source: IMF, *Rwanda: Selected Issues and Statistical Appendix*, 2004

Rwanda is predominantly an agriculturally based economy and the majority of agricultural production is subsistence. Notable from Table 2 is the stagnation in the share of different sectors. There has been no significant shift in the economic contribution of the various sectors.

Table 3. Rwanda: Sector Growth, 2000-2003
(constant prices)

	2000	2001	2002	2003
GDP Factor Cost	5.98%	6.70%	9.40%	0.94%
Primary	9.08%	8.32%	14.50%	-3.14%
-food crops	10.36%	8.75%	16.59%	-3.63%
-export crops	-12.82%	10.29%	5.33%	-15.19%
-livestock	6.51%	6.11%	2.88%	2.80%
-other	10.11%	3.06%	1.98%	2.91%
Secondary	3.22%	7.69%	7.97%	4.41%
-mining	9.09%	0.00%	-8.33%	-27.27%
-electric, gas and water	-12.50%	-7.14%	0.00%	0.00%
-manufacturing	-4.16%	7.81%	5.03%	-4.98%
-construct & pub works	13.89%	8.29%	12.16%	14.86%
Tertiary	3.56%	4.45%	3.75%	4.82%
-commerce & tourism	-1.46%	4.85%	5.03%	7.09%
-transport & communications	12.36%	7.16%	5.97%	-4.50%
-public administration	3.04%	1.13%	0.90%	10.00%
-services	3.12%	4.61%	3.40%	5.72%

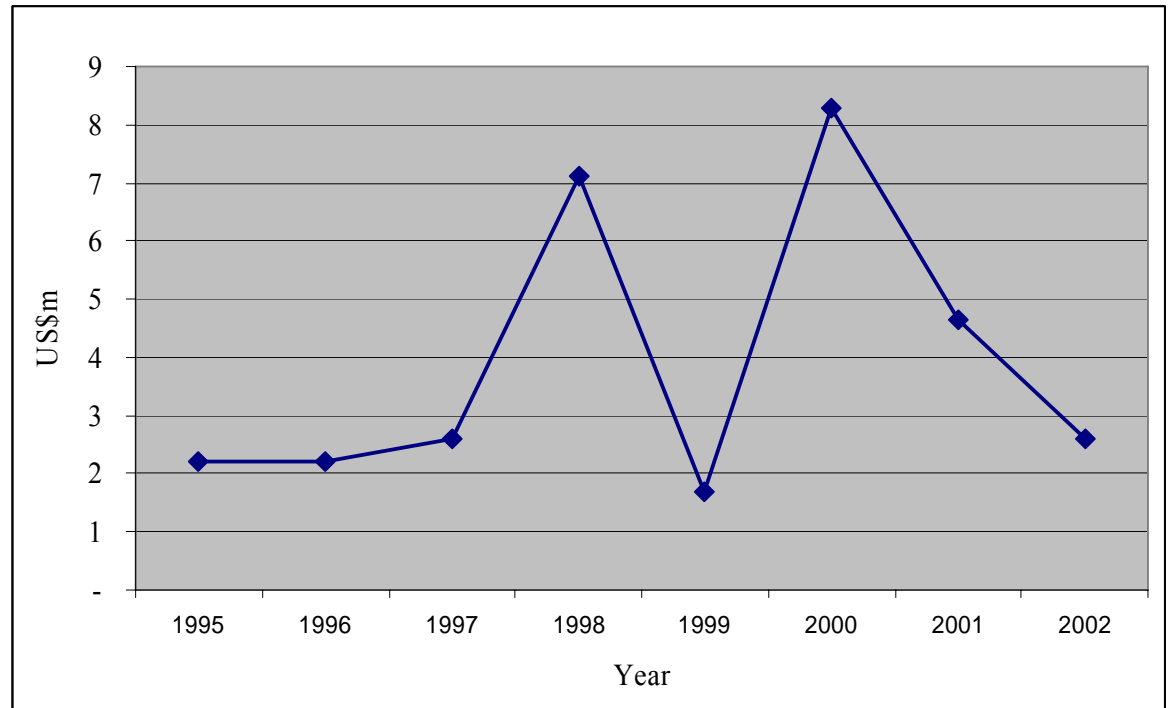
Source: IMF, *Rwanda: Selected Issues and Statistical Appendix*, 2004

Table 3 shows the highest growth has been in the tourism sector (largely as the base was almost zero). Public administration and public works have also shown significant growth on the back of large aid inflows since 1995. The two principal export earning exports, cash crops and mining, have experienced significant

swings in performance due to climatic variation and the fluctuating value of the RWF.

Foreign direct investment in Rwanda and the business climate

Figure 1. FDI Flows into Rwanda 1995-2002



Source: IMF and World Bank

While an increasing number of countries, including some regional competitors, have experienced increases in Foreign Direct Investment (FDI) and the share of investment in the form of FDI over the past decade, Rwanda has not. FDI in Rwanda remains very small, at an average of 0.24 percent of GDP per annum. The average for sub-Saharan Africa in the period 1997-2002 was 2.6 percent. The little FDI that has taken place has been associated with the government's privatization program – there has been very little greenfield investment.

Although the government has undertaken a range of policy reforms in the past years, it is clear from the data presented above that total investment remains low. Economic reforms that have taken place at the macroeconomic level in Rwanda do not appear to have altered the perceptions of the business community that the investment climate is generally poor.

Brief overview of the business climate in Rwanda

The World Bank's 'Doing Business' project provides a good starting point for assessing Rwanda's investment climate. Rwanda emerged well from the most recent Doing Business survey, and ranked as one of Africa's top performers. Even so, Rwanda's overall place was only 139th out of 155. More positively, for starting a business, Rwanda came 58th in the world, according to the survey, with it taking an estimated 21 days to complete the nine procedures required.

Rwanda fared less well on registering property, where it was ranked 124th, since it takes an average of 371 days and the process consumes nearly 10 percent of the value of the property. Rwanda was marked a poor 149th for getting credit, and an even worse 152nd for trading across borders. The survey found that exporters needed 14 documents and 27 signatures to move their goods, and the average time for export was 63 days.

On taxes, while Rwanda has a comparable number of taxes to the region (42 vs. 41), this is over two times the number of taxes paid in OCED countries. Rwanda performs better in terms of the time taken to complete tax forms.

Table 4: Doing Business in Rwanda

		Rwanda	Region	OECD
Starting a business	Procedures	9	11	6.5
	Time (days)	21	63.8	19.5
	Cost (% of income per cap)	280	215	6.8
	Minimum capital (% income per cap)	0	297	41
Dealing with licenses	Procedures (days)	17	20.1	14.1
	Time (days)	252	251.5	14.1
	Cost (% of income per cap)	510.9	1597.3	75.1
Paying taxes	Payment number	42	41	16.9
	Time (hours)	168	394	197
	Total tax payable (% gross profit)	54	58	45

Source: Doing Business, <<http://www.doingbusiness.org>>

Tax Policy in Rwanda

Tax and incentive policies are key parameters in defining a business climate. Taxes are essential for the financing of government activities, but at the same time, they should be set and administered to be as growth enabling as possible. Thus the revenue raising authorities (in the Rwanda case it is the Ministry of Finance that sets tax policy and the Rwanda Revenue Authority [RRA] which administers it) must set a tax policy which meets both needs.

Foundations and Background

At the time of this study, tax policy in Rwanda was undergoing some change. A new tax code for direct taxation, a new investment promotion code and a new schedule for investments under the customs legislation had been drafted. It was the intention of the Government of Rwanda to publish ('gazette') these three pieces of legislation together in 2006, at which time they would become law.

This study takes as its starting point the assumption that the three new tax codes will be duly gazetted and implemented. Much of this new legislation will amend and replace existing tax codes.

Existing legislation

- Constitution of the Republic of Rwanda, 2003
- Code of Value Added Tax 06/2001, 2001
- Law No. 14/98 establishing the Rwanda Investment Promotion Agency, 1998
- Law No. 8/97, Code of Direct Taxes, 1997
- Code for Fiscal Procedures, No. 9/97, 1997
- Rwanda Revenue Authority Act, Law No. 15/97, 1997
- Law No. 43/90 on promotion of exports, 1990
- Decree-Law on Property Tax, December 1973

Pending new legislation

- Law on Direct Taxation (covering personal income tax, corporate income tax, withholding tax, VAT implications and property tax on vehicles and boats)
- Law relating to the Investment and Export Promotion and Facilitation
- Incentives offered in the Customs Law - First Schedule

Rwanda has also concluded Double Taxation Treaties with three countries to avoid double taxation⁴.

Description of tax instruments described in this study

This study will concentrate on taxation of the corporate sector, which include primarily of:

- Corporate income tax
- Value Added Tax (VAT)

In addition, companies may have to pay the following contributions during their operations, depending on the type of business:

- Customs duty
- Excise tax
- Withholding tax

The general corporate tax rate is 30 percent of profits under the new tax law. Profits are defined as revenues minus depreciation, production costs and wages. The following can be deducted from revenue to form the taxable income base: all operational expenses (rent, advertisements, packaging, repairs etc.) related to the business.

Businesses with an annual turnover of less than RWF20 million may opt to pay a presumptive tax of 4 percent of turnover in lieu of the standard corporate income tax (but once chosen, they may not switch back and forth).

Capital investments are not deductible. Losses may be carried forward for up to five years.

VAT of 18 percent is charged on both local and imported goods and services. Businesses must keep invoices for five years. Taxable value is the selling price plus excise taxes, if applicable. Certain items are either zero-rated (subject to the VAT at the zero rate with refunds previously paid) or exempt from VAT (not subject to the VAT Act's provisions)⁵. There are no clear published criteria for the decision whether to assign an item to zero-rating or exemption. The differentiation allows businesses to obtain refunds of VAT already paid on inputs used to produce zero-rated items, while the VAT collected on inputs used to

⁴ Belgium, South Africa and Mauritius.

⁵ <http://www.RRA.org.zm/vat/pubs/Liability%20Guide.pdf>. Details will be discussed in the sector chapters.

produce goods exempt from the VAT cannot be refunded. Major zero-rated items⁶ are exports and diplomatic imports.

Tables 5 and 6 provide data on Rwanda's customs duties and VAT rates – with a comparison to other countries in the region.

Table 5: Regional VAT Rates

Country	VAT Rate
Rwanda	18%
Uganda*	17%
Kenya**	16%
Tanzania	20%
Zambia	17.5%
Mozambique	17%
Malawi	17.5%
Swaziland	14%
Lesotho	14%
South Africa	14%
Namibia	15%
Zimbabwe***	17.5%

* In 2005/2006 tax year there are plans to increase VAT from 17% to 18%

** In 2002 from 18% to 16%, A reduced rate of 14% is applied to the restaurant and accommodation industries.

***Rate increased from 15% to 17.5% on 1st September 2005

Table 6: Regional (Nominal) Tariff Rates

Goods	Capital goods	Raw materials	Semi-finished goods	Finished goods
Rwanda	0%	5%	15%	30%
Uganda	0%	0%-7%	15%	15%
Kenya	0%	0%-3%	5%-15%	20%-35%
Tanzania*	0%	0%	10%	20%
Zambia	0%	0%-5%	15%	25%

*Source PWC Tanzania Datacard 2005/2006

⁶ Designated in the Second Schedule of the VAT Act.

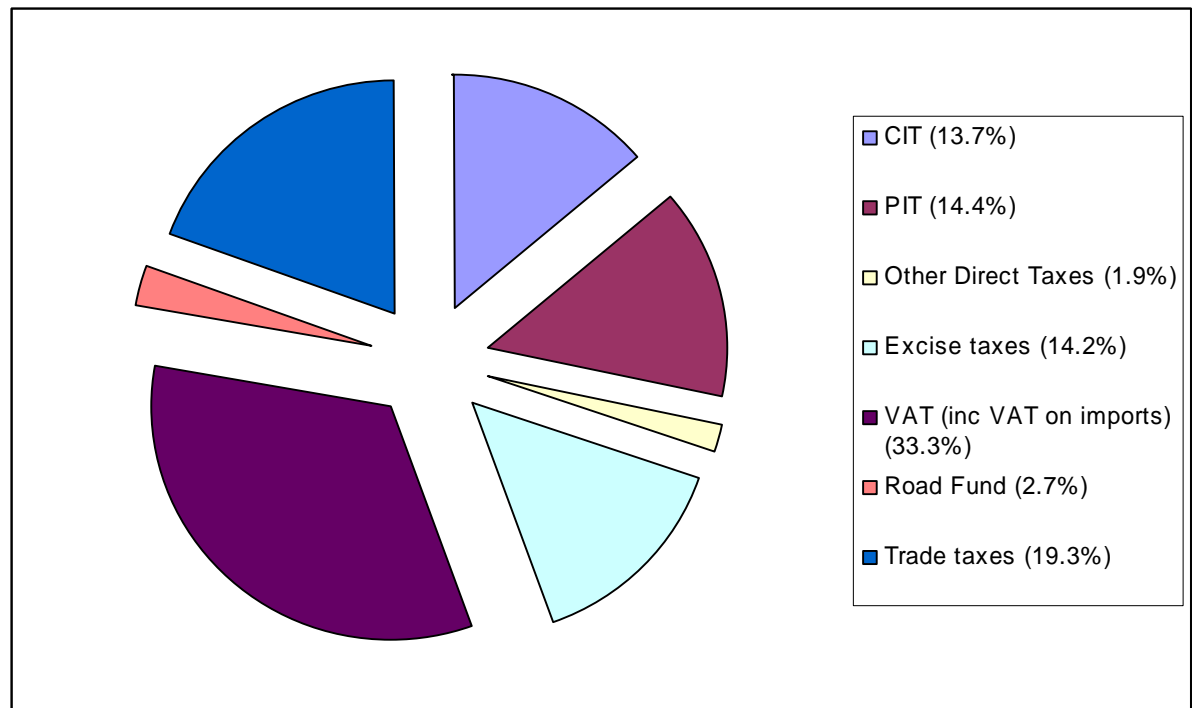
Tax revenue performance

From a macroeconomic perspective, tax policy in Rwanda has been increasingly effective at raising revenues, as measured by tax/GDP ratios. The current tax/GDP is around 14 percent of GDP, up from 9.2 percent in 1996.

Total central government revenues in 2004 amounted to 147.1 billion RWF (approximately US\$277M) 91 percent of which was collected through taxation. External donor financing plays a significant role in Rwanda's budget. In 2004 donor contributions (including assistance under the Heavily Indebted Poor Country Initiative) amounted to 126.7 billion RWF.

Rwanda's reliance on import taxes has steadily fallen, and now VAT contributes the largest share of total revenue (33.3 percent). Corporate and income taxes contribute similar amounts (13.7 percent and 14.4 percent respectively). Figure 2 illustrates the contributions.

Figure 2:



Source: RRA

2. ANALYSIS OF THE EFFECTIVE TAX BURDEN IN RWANDA

Assessing the effective tax burden - an introduction

A quantitative assessment of the effective tax burden in Rwanda requires a standardized metric, which takes all provisions of the tax code and incentives scheme in place to look at what a hypothetical new entrepreneur would face if he or she were to invest today in that sector. At the same time, qualitative analysis is also needed to determine how the tax/incentives scheme is applied in practice. This section presents both the qualitative and quantitative analyses of five key sectors in the economy—agriculture, manufacturing, tourism, mining, and finance—to present a comprehensive picture the absolute and relative tax burden.

Quantitative analysis of the effective tax burden

The concept of a marginal effective tax rate (METR) was created to analyze in a single measure how investment decisions are affected by the large number of provisions of the business and individual income tax systems, as well as by features of any property and wealth taxes, sales taxes including VAT, customs duties, and special incentive regimes such as tax holidays, that affect the incentives to invest. METR analysis is based on the standard neoclassical model of investment in which the level of investment is a function of the “cost of capital” faced by a firm – the minimum or “hurdle” rate of return that an investment must earn to be profitable. Although earlier research was mixed on the issue, the most recent empirical evidence confirms the basic assumption of this model – which investment does in fact react inversely to changes in the cost of capital (Gordon and Hines, 2002). METR analysts, such as King and Fullerton (1984), Broadway, Bruce and Mintz (1984) and many others, have taken the basic neoclassical model and modified it to take into account the net effect of all the provisions of a tax system on the cost of capital to the firm.⁷ The primary goal of an METR analysis is thus to describe this net effect of a tax system on investment incentives in a straightforward and intuitively appealing form.

The METR terminology naturally provides some insight into the nature of this tool. A METR is *marginal* because it is based on analysis of a prospective incremental investment – one that just breaks even, with its after-tax cost equal to

⁷ The analysis in this paper most closely follows the approach in Broadway, Bruce and Mintz (1984). For an application of the King and Fullerton (1984) approach to Burundi, see Zdzrow (1993).

its after-tax returns.⁸ It calculates the *effective* tax burden in that it captures the net effects of all the provisions of the tax system, rather than focusing on a single characteristic such as the maximum statutory corporate tax rate. And it is a *tax rate* in that it is defined as the difference between the gross of tax and net of tax returns to an investment – the “tax wedge” between gross and net returns created by the tax system – expressed as a percentage of the gross return.

The calculation of a METR requires careful specification of the characteristics of an investment in a specific asset in a specific sector, including the time path of its returns, the rate of economic depreciation of the asset, how the asset is financed, the economic environment in which it occurs, including the inflation rate, interest rates, and returns to equity, and all of the features of the current or proposed tax system that affect both the after-tax returns and the after-tax costs attributable to the investment, including all tax depreciation allowances, investment credits, interest deductions, special exemptions, etc., allowed under the income tax as well as any other taxes that impinge on investment decisions. Given this information, the analysis calculates the effective tax rate on a marginal or breakeven investment under the assumptions of profit maximization by the firm, competitive markets, and perfect certainty (e.g., with respect to future returns and inflation rates).

⁸ METR analysis is thus not well suited to analyzing tax effects on investments that generate above-normal returns.

Box 1: The Marginal Effective Tax Rate (METR)

The METR measures the extent to which the tax system reduces the real rate of return on investment, at the margin. More formally, the METR is defined as:-

$$\text{METR} = (\text{ROR}_{bT} - \text{ROR}_{aT})/\text{ROR}_{bT}$$

where ROR_{bT} and ROR_{aT} are the real rates of return before and after tax, and ROR is:

$$\frac{\text{Present discounted value of annual net earnings}}{\text{Capital Expenditure}} = \frac{\text{PDV}(E)}{K}$$

For example, let us assume that the rate of return on an incremental capital project is 20% before tax and 10% after, from the equation: $\text{METR} = (20-10)/20 = 0.5$ or 50%. The METR of 50% indicates that the tax system diminishes the real rate of return by 50%. The METR shows how much the tax system distorts investment incentives by driving a ‘wedge’ between the underlying profitability of a project and the after-tax return to the investor. The METR can be compared across projects, sectors, and countries. The larger the METR, the bigger the tax wedge. Differences in the METR reveal tax-induced biases in the incentives that drive the allocation of productive resources. In some cases, the biases are deliberate aims of policy, such as preferences for exporters or for manufacturers in certain locations. In many cases, however, the biases are unintended consequences of the tax system.

It is possible to have a METR which is zero and yet also revenue-positive, as long as the rates of return before and after tax are the same. This can be the case with, for example, 100% deductibility of investment in the first year.

The tax wedge appears at two levels—one arising from taxes on the company, and the second stemming from taxes on the remittance of earnings or capital gains to the owners. There are thus two METRS. The first is in terms of the returns seen by the company undertaking the investment. The second analyses the rate of return to the equity holders themselves rather than the company. The present paper uses the second approach.

A few technical assumptions for the METR calculations used in this paper are also worth noting. First, with the assumption of capital mobility in a global economy, we use an international real interest rate, which is determined in the international financial market, rather than in any individual “small open economy” such as Rwanda. For the same reason, we chose to use the G-7 average, rather than country-specific, tax rates on financial investment incomes to estimate the financing cost of capital.

Second, due to the lack of country-specific data, we use Canadian capital weights within any given business sector to estimate METR. This may sound problematic since Rwanda is not Canada. But there are good reasons why Canadian weights are used: it allows cross-country comparisons; capital and technology are increasingly mobile; absolute capital weights may vary across country but relative weights vary far less (e.g. manufacturing uses more machinery and less land

compared to agriculture); lastly, capital weights are not available in most African countries, including Rwanda.

Third, since the METR takes into account tax impact *at the margin*, any tax that is levied as a fixed amount that is not in proportion to the size of capital or income will not affect METR calculations. Therefore, any tax levied as a fixed amount will be excluded from our calculations. Such taxes include mainly local levies on immovable property including buildings, mining concessions, and farmland.

Summary of METR analysis in Rwanda

Table 7 presents METRs for the tax system in Rwanda as detailed in the new law. The analysis also provides METRs under two tax changes recommended by the proposed new investment act. Results are presented for five capital assets (machinery, buildings, inventories, and land) and for the five business sectors (manufacturing, tourism, agriculture, financial services and mining).

Table 7 presents METR for firms which are large enough to not qualify for the optional presumptive 4 percent turnover tax.

Table 7.1 shows the METRs across all sectors for large firms, for those with and without the investment allowance. Table 7.2 shows the same comparison for those firms that are entitled to a discounted CIT rate of 23 percent as a result of fulfilling the requirements in the new CIT law.

Table 7. Rwanda: Marginal Effective Tax Rate on Capital Investment in Rwanda, for Large Firms

7.1. With the general CIT rate of 30 percent					
	With no investment allowance				
	Manufacturing*	Agriculture**	Mining	Financial services***	Tourism
<i>Buildings</i>	22%	12%	19%	11%	13%
<i>Machinery & equipment</i>	22%	29%	26%	46%	23%
<i>Land</i>	-13%	-13%	-13%	-13%	-13%
<i>Inventories</i>	-13%	-13%	-13%	-13%	-13%
<i>Aggregate</i>	17%	7%	20%	28%	13%
	With investment allowance				
	Manufacturing*	Agriculture**	Mining	Financial services	Tourism
<i>Buildings</i>	-5%	-14%	-8%	-9%	-13%
<i>Machinery & equipment</i>	-5%	1%	-1%	35%	-5%

<i>Land</i>	-13%	-13%	-13%	-13%	-13%
<i>Inventories</i>	-13%	-13%	-13%	-13%	-13%
<i>Aggregate</i>	-7%	-10%	-5%	14%	-11%

7.2. With the reduced CIT rate of 23 percent resulted from the maximum tax discount of 7 percentage points

	With no investment allowance				
	Manufacturing*	Agriculture**	Mining	Financial services	Tourism
<i>Buildings</i>	16%	8%	14%	7%	9%
<i>Machinery & equipment</i>	16%	22%	19%	42%	16%
<i>Land</i>	-9%	-9%	-9%	-9%	-9%
<i>Inventories</i>	-9%	-9%	-9%	-9%	-9%
<i>Aggregate</i>	12%	4%	14%	24%	9%
	With investment allowance				
	Manufacturing*	Agriculture**	Mining	Financial services	Tourism
<i>Buildings</i>	-5%	-11%	-7%	-8%	-11%
<i>Machinery & equipment</i>	-5%	-1%	-3%	34%	-5%
<i>Land</i>	-9%	-9%	-9%	-9%	-9%
<i>Inventories</i>	-9%	-9%	-9%	-9%	-9%
<i>Aggregate</i>	-6%	-8%	-5%	14%	-9%

* For registered investment entities that operate in a Free Economic Zone hence are entitled to permanent income tax exemption, the METR is zero.

** For agricultural sector, both input and output are exempted from VAT.

*** Firms specialized in micro finance are entitled to a 5-year tax holiday; their METR is 4 percent.

The following observations can be drawn.

Land and inventory incur the lowest METR at a substantial negative rate, primarily because the only non-tax cost for land and inventory is the real cost of financing (financing cost net of inflation). Like most income tax systems around the world, Rwanda allows interest to be deducted in nominal terms from taxable income. When inflation is high, the tax benefit from the deduction for nominal interest expenses may more than offset the real financing cost to investors. As a result, the tax cost of a new investment (i.e., the METR) in land and inventory can be negative⁹. A negative METR does not imply a cash refund from the revenue authority, but rather that the METR associated with a new capital investment

⁹ Our simulation shows that, by reducing either inflation rate or debt financing, both of which would reduce the tax benefit from interest deduction, METR for land and inventory could turn to positive.

provides a reduction in total tax liability for overall business activities that generate income from both past and new marginal capital investments.

*For depreciable assets, buildings are taxed less than machinery and equipment (M&E), mainly because buildings last much longer than M&E and the tax depreciation allowance for buildings is more generous in relation to their useful life compared to that for M&E. By way of comparison, the tax depreciation allowance provided in the new law implies a useful life of 20 years for buildings and 5 to 8 years for M&E. Without the investment allowances, therefore, the tax depreciation allowance provides a *faster* write off for buildings than for M&E in relation to the useful life of these assets.*

Financial services sector is the most heavily taxed, followed by mining, manufacturing, tourism and agriculture. About 25 percent of the financial services sector is exempt from VAT and hence cannot claim input tax credit for VAT paid on capital inputs (mainly M&E). As a result, the METR is the highest for financial services among all five sectors. The METR for agriculture is the lowest since almost 50 percent of agricultural capital is invested in land and inventory, which are the lowest taxed assets (as explained above), and the sector is exempt for VAT.

The pattern of the METRs by asset type and by industry observed above can be similarly applied to METR for large firms that are entitled to investment allowances except that in this case tourism becomes the lowest taxed sector. Two points are worth noting: i) the METR for land and inventory are the same as their counterparts in the case without investment allowances, since investment allowances are irrelevant to non-depreciable assets such as land and inventory; and ii) the METR in the agricultural and financial sectors falls less significantly than that in other sectors (i.e. below 20 percentage points vs. around 24 percentage points). In the case of agriculture, this is because depreciable assets account for less than 50 percent of total capital assets (compared to around 80 percent in other sectors) so that agriculture benefits less from investment allowances than other sectors. As for the financial sector, the non-refundable VAT on capital inputs for a portion of its capital investment offsets the benefit from investment allowances.

The conditional Investment allowance, 50 percent for manufacturing, agriculture, mining and tourism and 40 percent for financial services, significantly lowers the METR for depreciable assets, particularly for buildings. As a result, within any given sector, the METR for large firms that are entitled to investment allowances is much lower than that for other firms that are paying CIT but not qualified to receive investment allowances.

With the reduced CIT rate of 23 percent and conditional investment

allowance (Table 7.2)

The CIT rate is reduced to between 23 and 28 percent, depending on the extent to which the conditional number of employees or total value of exports is met. Our METR analysis focuses on the lowest CIT rate of 23 percent, to highlight the impact.

The METR by asset type and by sector follows the same pattern as that shown above for large firms subject to the general CIT rate of 30 percent. That is, M&E are the highest taxed assets followed by buildings, and land and inventory; and financial services is the highest taxed sector followed by the mining, manufacturing, tourism, and agricultural sectors with the last sectors switching positions when the investment allowance is available.

In the case without the investment allowance, the reduced CIT rate (23%) lowers the aggregate METR for all sectors by 3 to 6 percentage points. The reduced CIT, however, increases the METR for non-depreciable assets compared with the case where the firms are subject to the regular CIT rate (30%). The main reason for a higher METR on non-depreciable assets is that a lower CIT rate reduces the benefit from tax allowances (e.g. interest deduction). When such loss (in tax benefit) outweighs the gain from the lower tax rate, the METR rises accordingly.

In the case where an investment allowance applies, the reduced CIT rate also reduces the aggregate METR for all sectors compared with the case where the same sectors are subject to the regular 30-percent CIT rate. The effect of reduced CIT on the METR in this case is trivial, however, compared to the effect where there is no investment allowance. This is because, for a given investment allowance or any other tax allowance, a lower CIT rate reduces the financial benefit from such tax allowances. In other words, when there is an excessively generous allowance (e.g. a 40 to 50-percent investment allowance), a reduction in the tax rate is a redundant incentive, and vice versa.

METR for tax holiday cases

Tax holidays (i.e. full income tax exemptions) are provided on highly selective bases. The METR corresponding to these tax holidays are the following:

METR is zero for those firms that qualify for a permanent income tax exemption, which is provided for foreign companies that have their headquarters in Rwanda or a *registered* investment entity that operates in a Free Economic Zone.

The METR is 4 percent for “micro finance” enterprises which are eligible for a 5-year income tax exemption.

For small firms

Table 8 shows the METR comparison for small firms under the following three different “provisional” taxpaying statuses: i) paying turnover tax but not paying VAT; ii) paying both turnover tax and VAT; and iii) paying company income tax and VAT.

The marginal effective tax burden on small businesses paying the turnover tax¹⁰ is higher than large businesses that pay corporate income tax and irrespective of whether they benefit from the 40 percent investment allowance (50 percent for priority sectors).

Table 8. Small Businesses: METR by Sectors in Rwanda

	Manuf	Agriculture	Mining	Tourism
Pay turnover tax but not VAT	49%	11%	52%	31%
Pay turnover tax and VAT	18%	11%	19%	14%
Pay company income tax and VAT	17%	7%	20%	13%
<i>Note: Simulation 3% turnover, no VAT</i>	<i>14%</i>	<i>9%</i>	<i>15%</i>	<i>11%</i>
<i>Large firms: CIT with Investment Allow.</i>	<i>-7%</i>	<i>-10%</i>	<i>-5%</i>	<i>-11%</i>

Much to its credit, the Rwanda small tax regime offers the choice of opting into the standard corporate income tax and VAT system for those small businesses with sufficient capacity. However, the two main disincentives for small businesses are the high costs of compliance for the standard regime, and the lack of information from tax authorities about which regime suits them better.

The METR for small firms that are paying the 4-percent turnover tax but not registered for VAT and hence cannot claim the input tax credit under VAT

Under this scenario (row 1), small firms incur a much higher METR by sector compared to large firms, with and without the investment allowance.

The main reason for this high METR for small firms is that the VAT paid on capital input (mainly M&E) is not refundable to small firms if they are not

¹⁰ Globally, taxable income accounts for a small portion of gross revenue, often less than 10% in many sectors. If we assume a ratio of taxable income to turnover of 10%, a 4% turnover tax is equivalent to a 40% corporate income tax.

registered for VAT. When small firms register for VAT and hence can claim input tax credits, the METR for small firms could be very close to that for large firms not having the investment allowance.

It is noticeable that the METR for firms in the agricultural sector (11%) is the lowest among all sectors. This is mainly because the agricultural sector is exempt from VAT for both its input and output. In other words, the agricultural sector does not have to bear any transaction tax on its capital inputs.

Among all types of assets, the METR on land and inventory is lower than that on buildings and M&E. This is because while METR measures tax impact on profit generated from capital investment, turnover tax is levied not only on profit but also on business expenses including both financing cost and depreciation expenses. For a given amount of profit, the higher the business expenses, the lower the after-expense profit and hence the higher the METR. Unlike depreciable assets, non-depreciable assets including land and inventory incur only financing costs but no depreciation expenses. Therefore, under a turnover tax that does not allow any write-off for expenses, the METR on non-depreciable assets is lower than that on depreciable assets.

The METR for small firms that are paying the 4-percent turnover tax and are registered for VAT and hence can claim the input tax credit under VAT

Under this scenario (row 2), the METR for small firms is much lower than that shown in row 1 where small firms have to bear VAT on their capital inputs. In fact, the METR in this scenario indicates that the tax impact on those small firms that are registered for VAT is close to that on large firms not having the investment allowance.

Noting that METR is an indicator for tax cost on income from new capital investment, the similarity between METR for small firms under the turnover tax and that for large firms under company income tax does not necessarily mean a similar tax burden measured in accounting terms between these two cases¹¹. In accounting terms, the average effective tax rate carries more weight in that it measures total tax paid as a share of total income. By considering only income tax and turnover tax under a given ratio of taxable income (under CIT) to turnover, one can easily convert the income tax rate to an equivalent effective turnover tax rate, and vice versa. For example, assuming the ratio of taxable income (under CIT) to turnover is 10 percent, a 4-percent turnover tax rate is equivalent to a 40-percent CIT rate, and a 30-percent CIT rate is equivalent to a 3-percent turnover tax rate. Our estimate shows that only when the ratio of taxable income to

¹¹See Chen and Bird (2002) about *marginal* and *average* effective tax rates as two distinct measures of tax impacts.

turnover reaches 13.3 percent does the 4-percent turnover tax and the 30-percent CIT rate yield the same tax payable under both tax regimes. Since most goods producers experience a lower profitability than 13.3 percent¹², and most small businesses in Rwanda are in the agricultural sector, the 4-percent turnover tax rate appears to be on the high side.

Small firms which opt to pay the company income tax and register for VAT and hence can claim the input tax credit under VAT

Under this scenario (row 3), small firms share the same taxpaying status with the large firms that are not entitled to any special tax incentives. Therefore, the METR for small firms is identical to that for large firms that are subject to the regular CIT rate with no investment allowance.

Main findings and policy simulations

In summary, four main findings can be drawn from the above METR analysis.

First, of all types of capital assets, land and inventory are the lowest taxed. This is because the only non-tax cost for land and inventory is the real financing cost, while the non-tax cost for buildings and M&E includes both real financing cost and replacement cost. Under company income tax, the provision for nominal interest deduction helps shield the financing cost; during a period of high inflation, the tax benefit from nominal interest deduction can be excessive. Under the turnover tax, which tax is levied not only on business income but also business expenses, the higher the non-tax cost of capital, the higher is the METR.

Second, for large firms, the financial sector is the highest taxed owing to its partial exempt status from the VAT. In the case without the investment allowance, agriculture is the lowest taxed sector owing to its large holdings in land and inventory, which are the lowest taxed assets. In the case with the investment allowance, the tourism sector is the lowest taxed owing to its high share in buildings for which the tax allowance is more generous than that for M&E in relation to actual replacement cost.

Third, the conditional tax discount may reduce the METR for “qualified” large firms, but such a reduction can be ineffective when it is applied in conjunction with the investment allowance. That is, a generous investment allowance and a reduced tax rate offset each other in providing tax benefits.

¹²For example, Thailand’s input-output table shows that the nationwide ratio of net operating surplus to total output is 12.5%; and the firm-based data generated by the tax department in Jordan shows that the ratio of taxable income to turnover ranges from 3 percent for mining and construction sectors to 6 percent for manufacturing sector and 16 percent to financial services.

And finally, for small firms, mining is the highest taxed sector, followed by manufacturing, tourism and agriculture. The gap in METR between sectors can be as wide as 41 percentage points for firms paying turnover tax and not registering for VAT. The sector gap may be narrowed to 8 percentage points when small firms do not bear VAT on their capital inputs either by law (i.e., being registered for VAT or being exempt from VAT on their inputs) or by business nature (e.g. when they rarely have to purchase inputs from VAT payers, or can pass on VAT paid on inputs on to consumers).

Based on the above findings, the main factor leading to tax differences among firms within a given business sector is the conditional tax incentives that are only available for selected large firms. To mitigate this tax distortion, an unconditional investment allowance at a rate affordable to the government could be introduced to replace all the present conditional incentives. This change would not only eliminate the tax distortion among firms carrying on the same business activities but also simplify tax administration and thus reduce the cost of revenue collection. For example, by eliminating special incentives conditioned on performance level, the RRA would no longer need to monitor taxpayer's performance on whether the qualified employment level has been sustained for 6 months, or whether the qualified investment assets have been kept in use for 3 years.

Regarding the turnover tax payable by small business, whether the current 4-percent turnover tax rate is too high or too low will be always debatable. Since the new law provides an option for small firms to pay CIT rather than turnover tax, a turnover tax rate at the high end might be seen as being helpful in motivating small firms to enter the CIT net by opting out from paying turnover tax. However, considering that the turnover tax is a much simpler tax for small firms to comply with since it does not require bookkeeping except for revenue. In a low-income country like Rwanda, a properly rated turnover tax could be more effective than an income tax in expanding the tax net among small firms, particularly the extremely small ones. To err on the side of saving the cost of revenue collection and motivating more small firms to start paying tax, we propose lowering the turnover tax rate.

In this regard, two further METR simulations are shown in Table 9 for an unconditional 10-percent investment allowance for all company income taxpayers and for a lower turnover tax rate.

Simulation 1: An investment allowance of 10 percent for all firms, both large and small, that are paying the general 30-percent CIT rate

A 10-percent investment allowance for all may achieve a level of METR by sector

that is similar to the level of METR with a reduced CIT rate of 23 percent that is given to highly selective firms. This policy option would treat all firms equally by providing an unconditional investment allowance to all; and this unconditional investment allowance should be introduced to replace all conditional incentives provided in the New Law (e.g. tax holidays, tax discounts and conditional investment allowances). With this change, the revenue authority would no longer need to monitor the number of years during which “qualified” investors have to maintain their capital investment.

The main purpose of this policy simulation is to illustrate an alternative to the present excessively generous and in some case redundant tax incentives that are intended to benefit only a handful of large investors. This alternative would also provide an equal tax incentive to all CIT payers to invest more in Rwanda.

Simulation 2: 3 percent turnover tax for small firms that neither opt for paying company tax nor bear VAT on their business inputs

Besides registering for VAT or being exempt from VAT on business inputs by law (e.g. the case for farmers), there are two possible cases in which small firms do not bear VAT on their business inputs. First, these firms may be in a business in which they rarely have to purchase their inputs from VAT payers (e.g. producers of handicrafts); and second, they may be in a business in which they are able to forward VAT on their business inputs to purchasers of their products (e.g. small retailers selling their products in a niche market where demand is greater than supply and inelastic). In these two cases, small firms virtually do not bear any significant VAT on their business inputs even if they choose not to register for VAT.

A comparison between Table 9.2 and Table 9.1 shows that METR for small business paying a 3-percent turnover tax would be similar to the level of METR for large firms paying the 30-percent CIT with a 10-percent investment allowance. Annex G provides this information in more detail.

Table 9: Marginal Effective Tax Rate on Capital Investment in Rwanda, Policy Simulations

9.1. Policy simulation: Regular CIT rate of 30 percent with a 10-percent investment allowance					
	Manufacturing	Agriculture*	Mining	Financial services	Tourism
<i>Buildings</i>	18%	8%	15%	6%	9%
<i>Machinery & equipment</i>	18%	24%	22%	44%	18%
<i>Land</i>	-13%	-13%	-13%	-13%	-13%
<i>Inventories</i>	-13%	-13%	-13%	-13%	-13%
Aggregate	13%	4%	16%	25%	9%
9.2. Policy simulation: A turnover tax of 3% with no VAT on input by law, or by business nature					
	Manufacturing	Agriculture*	Mining	Financial services	Tourism
<i>Buildings</i>	11%	9%	10%	NA	9%
<i>Machinery & equipment</i>	19%	20%	19%	NA	20%
<i>Land</i>	3%	3%	3%	NA	3%
<i>Inventories</i>	3%	3%	3%	NA	3%
Aggregate	14%	9%	15%	NA	11%

* For agricultural sector, both input and output are exempted from VAT.

Concluding Remarks and Recommendations

The Rwandan business tax structure, as set out in the new law is simple and straightforward with a uniform tax rate that is in line with the average CIT rate of both its neighbors and OECD countries.¹³ The generous tax depreciation allowance for all investors makes Rwanda an attractive investment location in terms of tax.

Several issues in the new law merit further fine tuning, however, in order to achieve a higher level of efficiency, simplicity and fairness. Additional tax changes are also needed to strengthen the “fiscal contract” between the state and the private sector and to bring more small firms into the tax net. For these purposes and based on our METR analysis, we make the following recommendations.

- The current special tax incentives including both income tax exemptions

¹³The average CIT rate for OECD countries is 29 percent; excluding G-7 countries, the average CIT rate among the remaining 23 OECD member countries is 26 percent.

and tax discounts and investment allowances for selective firms should be re-examined. If necessary and provided that the revenue impact is neutral, an unconditional tax incentive could be substituted for all income taxpayers.

Special tax incentives based on highly selective conditions (such as the present incentives) given according to the business sector or performance level of firms (e.g. the amount of investment or the jobs created), or the business location, or firm size, or nationality of investors, are harmful not only to market efficiency but also to the overall investment environment¹⁴. A truly efficient tax system requires not only a uniform tax rate but also a uniform tax base. To accommodate the Government's need for revenue and taxpayers' desire for low tax burdens, the best uniform tax base is the broadest one for all with a limited number of leaks from the tax base resulting from incentives being given to special interest groups. A sound income tax structure should therefore tax all firms at the same rate and on the same tax base; and the ideal tax incentive for business is a lower uniform tax rate for all. To move in this direction, a universal investment allowance that is affordable to the government could be provided for all investors in Rwanda.

- Reduce the current 4-percent turnover tax to 3 percent, particularly if effective tax rates were to be reduced for all CIT taxpayers.

A turnover tax is commonly used as a presumptive measure to curb tax evasion among small firms while reducing administrative costs. This tax is useful particularly in the early stages of developing a modern tax system when the number of business income taxpayers accounts for only a small proportion of the total number of business entities.

This is the situation in Rwanda. Statistics shows that there are nearly 70,000 micro and small-scale enterprises (MSSEs) in Rwanda¹⁵. By way of contrast, there are fewer than 3000 registered companies paying national taxes, among which there are 280 firms defined as being "large taxpayers," around 1500 VAT registered companies, and around 1000 companies paying the 4-percent turnover tax. In other words, there are over 60,000 MSSEs outside the tax net in Rwanda.

Currently small businesses may choose a 4-percent turnover tax. Expanding the tax net among small firms may therefore be undertaken in two simultaneous steps: on the one hand encouraging those outside the tax net to pay the turnover tax, and on the other hand encouraging those who are now paying the turnover tax to

¹⁴There are numerous studies supporting this observation. For a recent thorough study on investment incentives in Jordan, see Chen (2004).

¹⁵Rwanda Private Sector Federation (2005).

consider paying income tax. This later step is important as it helps firms ‘graduate’ to full corporate income tax and helps instill a culture of record keep which is good business practice.

It is important that the benefits of, and obligations from, paying taxes should be explained to all small business enterprises in Rwanda. On the other hand, since the second step involves fewer small firms but requires business having a much more sophisticated knowledge of accounting compared to the first step, the success of the first step is more critical to expansion of the tax net among MSSEs.

Box 2: Presumptive Taxes in the Region

- Tanzania impose a presumptive tax on resident businesses with a turnover not exceeding TZS 20 million (\$16 556), which differs depending on whether accurate records are kept or not. It is a complex system with a base amount per each of the three tier levels, plus a percentage of revenue ranging from 1.3% to 3.3%;
- Uganda impose a small business tax on a sliding scale basis which is equal to a maximum of 1 percent of turnover on businesses with a turnover up to 50 million Ugandan shillings (\$27 000);
- Zambia has a presumptive tax system of 3 percent of turnover for small business with an income not exceeding ZK200 million (\$51 000)

Source: FIAS (2005)

The initial focus therefore, should be on expanding the number of firms within the turnover tax net. Given that Rwanda has a small open economy, a sizeable informal sector and is significantly non-monetized, the turnover tax is a better tool than the income tax for purposes of engaging the vast majority of small businesses to participate in a “fiscal contract” with the state¹⁶. Considering that the majority of these small firms are in the agricultural sector and perhaps have a turnover below RWF 12 million and hence do not have to pay tax by law, lowering the turnover tax could be critical to bringing this segment of business into the tax net¹⁷.

- Substantially increase the depreciation basis that can be deductible as business expense in order to encourage small businesses to increase capital investment while “upgrading” them from paying turnover tax to paying income tax.

¹⁶ See recommendation 5 for “user charges” as another means for engaging small business into the “fiscal contract” with the State.

¹⁷ See Recommendation 4 for the argument against the excessive generous exemption for agricultural income on the ground of tax integration.

In the new law (Article 25), “if the depreciation basis does not exceed five hundred thousand RWF, the entire depreciation is a deductible business expense.” This provision has two merits in terms of benefits for taxpayers: simplifying accounting for depreciable assets with a small residual balance and speeding up depreciation for a small amount of new capital investment. However, RWF 500,000 (less than \$1,000) is an amount too small to show these tax benefits, particularly when it is compared with the 50-percent investment allowance available to a handful large firms on their investment of over RWF 30 million, which is equivalent to an immediate write-off of RWF 15 million (more than \$25,000).

It is reasonable, therefore, to increase the fixed amount of total depreciable assets that can be expensed from the current level of RWF 500,000 to RWF 3 million. Although the latter allowance should be available to all, it would benefit small business the most and hence encourage them to participate in the income tax system.

- Reform the legal framework to provide local governments with the power to tax beyond property on the one hand and prohibit any unlawful local levies on the other.

All major local taxes in Rwanda relate to immovable property and all were decentralized from the central to local government in 2002. These taxes include those on rental income; and the property tax on buildings, undeveloped land, farmland, and mining concessions. Owing to the lack of statistics, it was not possible to estimate the amount of local tax revenue in terms of its share in GDP, nor can we assess whether the current local tax revenue is adequate or justifiable in terms of financing government services related to property values. But firm interviews indicate that business taxpayers question the legitimacy of many local levies unrelated to property.

Three issues need to be clarified in this respect. First, local taxes including user charges are necessary to finance public services provided by local governments. Second, local governments should be given the power to levy taxes or user charges unrelated to property. Finally, local taxes and user charges should be levied only by law and citizens and business entities have the right to refuse paying any levy that is unlawful.

Sector Analysis

Agriculture

Agriculture is the largest sector of the economy and accounts for 41 percent of GDP and an estimated 90 percent of economic activity (EIU 2005). Coffee and tea are the two largest commercial exports with estimates of \$25.6 million and \$27.5 million exported in 2005 respectively.

The majority of farms are informal and subsistence based. The vast majority of farms operate outside of the tax net, either because produce is not sold commercially or because the size of the business is so small.

Summary of the tax/incentive system

Farms that do operate as a business, mostly on a sole proprietor basis, receive favorable tax treatment.

Corporate Income Tax

The first 12 million RWF of farming income per annum is exempt from personal tax (Article 18 of the new law).

Farmers earning over RWF 12 million, but less than RWF 20 million, would also benefit from the provisions in the new law for small businesses (see Section X.X) – including the provision to choose a turnover tax of 4 percent of income.

Co-operatives however, (a common form of business organization in the tea sector for example), pay the standard corporate income tax of 35 percent.

Value Added Tax

All farming outputs and inputs (including equipment) are VAT exempt. The same is not true however, for value added processing of agricultural products.

Most farmers in Rwanda would also benefit from the provisions in the new law for small businesses (see Small Business discussion) – as they would have a turnover of less than RWF20 million. Including the provision to opt to register for VAT is they so wish.

Council Levies

Most local governments levy a business license fee on commercial farmers of between RWF1, 000 and RWF 2,000 per annum.

Investment Allowance

Agriculture is one of the ‘priority sectors’ identified by Rwanda Investment and Export Promotion Agency (RIEPA). As such, it qualifies for a 50 percent investment allowance under the new tax code. Further, qualified and approved investors under the new investment code will be able to import agricultural equipment duty free.

Customs and Excise Duties

Customs duties on agricultural equipment and fuel constitute probably the largest tax impact on the agricultural sector (levied at 30 percent and 15 percent respectively). Fuel also faces an excise duty of 37%. Fertilizers and ‘other agricultural inputs’ are zero rated for import duties.

Box 3. Lessons on Rural Land Taxation from Elsewhere in Africa

While taxing rural land is fraught with difficulties, there are some experiences from recent history which offer some insights.

In the case of rural land taxation, decentralization of valuation and enforcement activities promotes efficiency. Recent successes with active and effective local Valuation Offices in Zambia have demonstrated this.

Some form of taxation (Flat-rate or site-value) is useful to encourage active land use, as opposed to speculation. Land owners have greater incentive to maximize the productivity of their land when owning it imposes real costs. Local authorities in Kenya in particular have attributed the rapid development of Nairobi and other cities in the 1970s to improved application of land taxation.

Site-value taxation is preferable to flat-rate taxation, because it is more accurate in terms of determining ability to pay taxes, identifying property owners as beneficiaries of public expenditure on social and economic infrastructure, and is more neutral than income taxes with respect to resource allocation. Arguments have been made that taxing development tends to discourage investment, but in the case of agricultural land, site-value taxation can be made dependent on soil quality (representing productive potential) rather than physical improvements.

Research and data management systems for comprehensive and accurate valuation are critical to the success of such systems. Establishing land value need not be a complicated process; in Zimbabwe a simple equation based on land attribute classifications has proven effective. In Tanzania, reforms aimed at strengthening cadastral records and tax administration since 1991 have resulted in visible improvements in collection efficiency.

Sources: Ahene (2000), Khan and Khan (1998)

The Tax and Incentive Regime in Practice

Tax is not a major issue constraining investment in this sector. Other factors are more important in driving growth and investment in this sector, such as land tenure reform, lack of skills, access to credit and poor rural infrastructure.

Corporate Income Tax

In practice, very few farmers pay corporate income tax. This is either due to official incentives (outlined above) or lack of compliance. Non-compliance is due to a combination of a lack of understanding of tax obligations and geographical remoteness. Such a situation is common in countries with a large number of smallholder farmers.

VAT

‘Exempt’ status with VAT can often lead to a high tax burden, as the exempt business must pay VAT on inputs but cannot charge VAT on outputs (or is forced to pass the additional cost on to the customer).

In the Rwandan case however, because both agricultural inputs and outputs are exempt, the result is that VAT does not apply in the sector.

The extent of tax breaks, combined with the vast amount of non-compliance, results in very little tax paid by the sector. With few exceptions, the agricultural sector only contributes to the tax revenue through the business license fee and other municipal taxes, and indirectly through the fuel import and excise duty. This tax treatment significantly advantages agriculture, which makes up the bulk of Rwanda’s economic activity and from which the majority of the poor gain their livelihood.

While the tax regime is generous, the fact that farmers receive such benefits in the early stages of development makes the ‘graduation’ process (to value-added processing, or to a turnover greater than 12 million RWF) more difficult than otherwise.

Box 4: Should Agriculture be exempt from VAT?

It is a common feature that value added in agriculture is taxed relatively lightly. The sector receives ‘special’ treatment because:

- In many developing countries agriculture is outside the formal sector
- Farmers are remotely located making education and compliance difficult
- Agriculture has seasonal revenues
- Exempting, or zero-rating, agriculture is seen as a way to pursue wider social objectives such as lowering the price of food, and supporting poor communities (predominantly rural).

Many of these features are not unique to agriculture and there is no *a priori* evidence that agriculture deserves special treatment. The reality however, is that special provisions are usually provided. The ‘cleanest’ of these is to zero-rate agricultural inputs, although this creates its own problems in terms of defining what is destined for agricultural use or not. Another option is to exempt inputs from VAT although this can lead to ‘exemption creep’. Once in place such schemes are very hard to undo and there are few examples of any country, developed or developing, which effectively moves toward graduating agriculture to a standard tax system. Complications are compounded when thresholds are introduced in an attempt to capture tax on value added from larger farmers.

Source: ‘The Modern VAT’, Ebrill, L., Keen, M., Bodin, J-P and Summers, V. (2001)

Other Issues

Rwanda has a significant tea and coffee sector, both of which contribute significantly to export earnings and which are smallholder based. As with other smallholders, these farmers pay very little tax. However, OCIR-Café (a statutory body performing various functions such as buying, grading and export marketing) charge a levy of around 3% of f.o.b. price. Tea grower cooperatives pay a 0.5RWF levy per kg green leaf as a District tax and 0.4 RWF/kg green leaf to the tea out-growers association called FERWATHE. There is some debate around the value for money provided by these fees.

Analysis of the Tax Regime

The overall aggregate METR on capital deployed in agriculture is only 7%, which is the lowest of all the sectors. The principal reason is that a large share of capital used for farming is in land and inventory, which benefit significantly from a tax subsidy during periods of high inflation (as discussed earlier).

If the 50% Investment Credit Allowance is incorporated from year one of operation, the METR falls to -10%.¹⁸ As agriculture's biggest investment is land, which does not depreciate, the benefit of the investment allowance for depreciable assets is felt most acutely in other sectors.

The VAT exempt status of inputs and outputs also contributes to the low METR for agriculture.

Recommendations

- **Investigate ways to amend the new tax code to bring farmers into the tax net.**

Smallholder agriculture is notoriously difficult to tax, and there are good arguments as to why this sector merits special treatment under the tax code. However, while it may appear a distant prospect, as the economy grows more farmers will become commercially viable and should enter the tax net.

One option is to introduce a land tax specific to agriculture based on the site value of land (Box 3). This process would need to progress step by step with the broader land reform process

It may be most appropriate for farmers to pay tax at the local level, given their remoteness from RRA offices and as municipalities often have better information on their own rural economies. It is very important that municipalities only levy taxes clearly defined in legislation, and do not introduce their own taxes which have no basis in law.

- **The turnover threshold for exempting income from farming and agricultural activities should be halved in order to improve integration between personal income tax and taxation of small business including small agricultural firms.**

Article 18 of the new code, providing exemption on farm income over RWF 12 million, is probably overly generous.¹⁹ A comparably sized non-farm enterprise would pay 30% tax on all business profit over RWF1.2 million. Further, Article 18 creates a hurdle for farmers to move from small to medium/large scale operations as once a farmers earns over RWF12 million per annum, the whole amount becomes subject to tax at the 30% rate.

¹⁸ A negative METR is possible if the tax treatment of the marginal project is so generous as to provide a subsidy to the firm's whole portfolio of projects.

¹⁹ The New tax code (Article 18) is unclear whether the RWF 12 million refers to revenue or net income (profit). Either way, it is a generous provision.

The turnover threshold for exempting income in farming and agricultural activities should be reduced by 50 percent to RWF 6 million²⁰. Farming and agricultural firms with a turnover above RWF 6 million should be taxed in the same manner as other small business under the turnover tax with an option to pay company income tax.

- **Similarly, with the VAT exempt status of the sector is generous.**

Farmers able to purchase commercial inputs (seed, fertilizer, machinery) are likely to be in a position to pay some tax. In the medium term, Rwanda should investigate moving to a system where farming inputs are VAT-able, but outputs are zero-rated. This would protect consumers (the poorest of the poor) from higher food prices caused by introducing VAT, while also allowing farmers a significant benefit (as they could claim the input credits back).

While it is tempting to suggest reform of the OCIR-Café and OCIR-The levies (which amount to export taxes) – these are matters best left to the industry itself to resolve.

Mining Sector

Although the mining sector in Rwanda is small (contributing less than 1% of GDP) it contributes significantly to exports. Minerals contributed 29.71% of all exports in 2004, second only to coffee.²¹

Much export growth has been due to a rapid expansion in the world price of Colombo-Tantalite (Coltan). Prices leveled off in 2002 but rose again in 2004, resulting in \$28.5 million of mineral exports.

Other ores mined are Cassiterite, Wolframe and gold. In addition, many other ores, precious stones, semi-precious stones, industrial substances and materials used for construction are mined and quarried.

Labor intensive, small-scale artisan miners dominate the mining industry in Rwanda. This accounts for the high employment figures in the sector. In 2004 an estimated 50,000 people were involved in the mining. The nature of the mining industry in Rwanda is likely to change in the future. There is an active drive by

²⁰ Assuming a ratio of value-added to the gross proceeds of 10 percent, a turnover of RWF 6 million indicates an income of RWF 600,000. This amount, compared to RWF 1.2 million, would be closer to the exempt amount of RWF 360,000 under the personal income tax.

²¹ The Mining and Geology Policy, 2004, (MINITERRE)

the government of Rwanda to attract capital-intensive foreign investment in the mining sector.

The privatization of the state owned mining company (REDEMI) is under review, and has drawn interest from large mining conglomerates in Australia, the USA and South Africa. The government is also considering granting additional mining concessions to interested international investors.

As the government seeks to attract new large scale mining investments into the country it needs to guard against alienating small scale miners. Although there are significant benefits to the economy through the attraction of large-scale mining investments, government must also not overlook the economic benefits of small-scale mining in terms of job creation and poverty alleviation. It is estimated that in the order of 13 million people in about 30 countries are directly engaged in small scale mining. Table 10 illustrates the estimated number of small scale miners in key competitive and comparative countries in Africa.²²

Table 10: Employment in the mining sector; Regional comparison.

Country	Number employed
Rwanda	50,000
Burkina Faso	100,000 – 200,000
Ghana	200,000
Malawi	40,000
Mozambique	60,000
Tanzania	550,000
Zambia	30,000
Zimbabwe	350,000

Source: IIED Small Scale Mining, Rwanda Ministry of Mining and Land Affairs (MINITERRE)

Government has recognized this and through the privatization of REDEMI is seeking from bidder's information on how they will support, assist and help develop small scale miners.

Large scale investors can play a very important role by helping reduce the barriers currently facing small scale miners, by for example:

- Helping small scale miners obtain much needed access to finance;
- Improving health and safety and working conditions and reducing exposure to harmful minerals;
- Training artisan miners in order to improve productivity and efficiencies and thus reducing prices of production and increasing production quantities; and

²² IIED, Artisan and Small Scale Mining, 2003, pg v11

- Reducing the effect on de-forestation and on the natural habitat caused by small scale mining.

Summary of the tax and incentive regime

Corporate income tax

The standard rate of corporate tax (30%) applies in the sector.

As in all sectors, businesses with an annual turnover below RWF 20 million may opt for the 4% turnover (presumptive) tax.

Value Added Tax

The standard VAT rate of 18% is applicable to limited services in the mining industry.

Most mined minerals are exported from Rwanda in an unprocessed or semi-processed form and are therefore zero-rated and not subject to VAT.

Incentives

A number of incentives are proposed in the new investment code for registered mining investors.²³

- A 50% initial investment allowance in the first year of purchasing new or used business assets, which are held for a period of at least 3 years. This is however, only applicable to investments exceeding RWF 30 million (approximately \$55 000).
- No import duties on machinery and raw materials;
- Employment incentives ranging from 2% to 6% for employing between 100 – 200 employees and more than 900 employees respectively;
- Payment of VAT can be deferred on the importation of goods to the time of the sale of those goods; and
- Organizations which import plant, machinery and equipment which are subject to VAT pay a single flat rate fee of 5% of the CIF value of the imported item, in lieu of all taxes, including import duties, VAT and others which would normally be imposed on such goods.

²³ Registered Investors are investors who invest a minimum capital equivalent of \$250,000 (international investor) and \$100,000 (local investor) in new business assets and in the expansion, restructuring and rehabilitation of an existing business.

The industry benefits from accelerated depreciation rates afforded to all organizations, namely:

- The construction and reconstruction of buildings is depreciated at a rate of 5% per annum;
- Machinery and equipment is to be depreciated at 25% per annum; and
- Computers depreciate at a rate of 50% per annum.

Any business that exports commodities or services of between \$3 million - \$5 million in a tax period is entitled to a tax discount of 3 percentage points; exports in excess of \$5 million are subject to a 5 percentage point tax discount.

Duties and Excises

Duties on the importation on capital goods and raw materials are most applicable to the mining industry, which are levied at 0% and 5% respectively.

Tax and incentive system in practice

Corporate income tax

The mining industry in Rwanda is dominated by small scale artisan miners, most of which do not pay any corporate tax. Small scale artisan miners sell their minerals to co-operatives and other large mining organizations who then market and export the minerals, either before or after processing.

These organizations and co-operatives do form part of the tax system and pay corporate tax. Total revenue from these organizations and from the few mines, which do pay corporate tax, however, is not significant in the context of total revenue.

There is currently only one large scale mining operation, of which we are aware, that uses mechanized mining practices. Capital intensive mines are unlikely to be affected by corporate taxes in the early stages of development.

Artisan miners are apparently paying several local taxes. Artisan miners pay municipal mining licenses and a per hectare local mining land tax. In addition, they appear to be paying a local municipality tax based on the amount of natural resources produced which in some cases is considerable, and appears to have a questionable basis in law.

Withholding tax and reverse charge VAT associated with the importation of overseas based services has a large impact on the mining industry, especially in

the case where local specialized skills are not available, such as geologists and other exploration specialists.

The national tax rate in Rwanda, applicable to the mining industry compares favorably with competitive destinations in Africa. A number of developing countries have different tax rates for the mining industry and some even differ by type of mine. In general mining tax rates are higher than national tax rates.

Most artisan miners in Rwanda are operating outside the tax net and do not pay any form of income, profit or personal tax (PAYE) and are not VAT registered, resulting in a considerable amount of potential revenue lost to the revenue authority.

The payment of the municipal based turnover tax by artisan miners is currently being viewed by them as a type of turnover tax, which in the future will make it more difficult for the authorities to formalize them, as the introduction of any other form of turnover or profit tax will be seen by them as a form of double taxation and is likely to alienate them from the formal system.

Value Added Tax

Most mining organizations are not burdened by VAT, due to most minerals being exported either in a processed or unprocessed form.

Small scale artisan miners, some of which are above the VAT threshold, are not registered nor pay VAT.

Large registered investors in the mining industry are also not impacted by VAT on imports. These organizations either opt to pay the flat rate 5% importation charge or defer the payment of VAT on importation, which is invariably not paid due to the zero rating of export goods.

VAT has a very limited effect on the mining sector in Rwanda as most minerals which are mined, are exported, and therefore are zero rated for VAT.

Large registered investors benefit from the deferment of VAT on imports and the flat rate tax on imports, which is consistent with international best practice, where mining companies pay very limited import duties if any at all. Concessions such as VAT deferment and flat rates are only applicable to larger registered investors and currently discriminate against the smaller artisan based organizations.

Duties and Excise

Duties and excise rates and exemptions in the mining industry are comparable to mining industries in other countries. Large scale mining companies do not consider import duties are large burden, as the importation of capital goods is free of duty and on items where duties are charged, registered investors tend to pay the 5% flat rate in lieu of any duties, VAT and other charges.

Registered investors benefit from paying no customs duties on raw material imports, this is particularly applicable to imports from the Democratic Republic of Congo (DRC) which, due to the political instability in the country are being channeled and exported from Rwanda and Uganda. This low import duty actually discourages cross border smuggling from the DRC.

Incentives

Very little exploration has been done in the mining industry in Rwanda resulting in a sever lack of knowledge of the potential of the mining industry. Although the government is trying to facilitate this, there are certain regulations in the tax code which actually prohibit such research, such as: withholding tax and reverse charges on VAT for services performed by international consultants, geologists and other specialists

Incentives are currently focused at attracting large scale international investors and currently discriminate against small scale artisan based miners, creating inconsistencies in the application of tax policy.

Some large organizations, have managed to negotiate individual investment agreements and benefit from additional incentives such as income tax holidays.

Other Issues

Analysis of the tax/incentive regime

The overall weighted average METR on capital in the mining sector is 15% without the investment allowance. This rather low tax cost reflects the fact that machinery and equipment used for mining generally have a longer useful life compared to those used by other sectors. The economic depreciation rate, or replacement cost, for M&E used for mining is low when compared to M&E used by other sectors. For the given tax M&E for mining, which contributes to the lower METR on capital invested in mining sector. Note should be taken of the fact that the METR in the mining sector, in order to ensure consistency with studies to be conducted in other regional countries, used inputs, assumptions and weightings based on international best practice. The resulting effect is that the

METR is applicable mainly to large scale mining operations that tend to use highly mechanized and capital intensive means of extracting mineral as opposed to very labor intensive small scale miners which are labor intensive.

Recommendations

The overall tax system put in place by recent reforms in Rwanda supports the growth of the mining sector, especially the large scale mining sector. Possible areas for further improvement include.

- **Review system of municipal based taxes with a view to establishing transparency and certainty, i.e., to eliminate discretion**

The levying of discretionary and ad-hoc taxes at municipal level is a major stumbling block towards the formalization of artisan miners and does not seem to have any base in law. This is an issue across the whole economy but is a particular concern in the mining sector.

- **Formalize artisan and small-scale miners through enforcing the small business presumptive tax**

Artisan and small-scale miners currently operate completely outside of the formal tax and business environment (personal, income or profit based tax). This is a common problem in economies with a large artisan mining sector. It is extremely hard to identify an effective means of bringing them into the formal tax system.

One solution is to put the burden of collection of a presumptive type turnover tax onto the larger corporations and co-ops who buy from artisans. This has met with success in some cases, such as in tin mining in Malaysia. However, in many cases, especially relating to small highly precious stones, this has had a negative effect resulting in a drastic increase in smuggling and is not recommended.²⁴ Instead, the existing presumptive should be enforced perhaps by working with co-operatives and other large agents, who principally buy from artisans.

Government needs to illustrate and provide incentives to encourage this formalization by, for example:

- Extending the current benefits afforded to large registered investors to artisan miners;
- Explain the elimination of the municipal production tax in favor of the presumptive tax;

²⁴ Mining Taxation in Developing Countries (J. Otto, et al), 2000

- **Explain the benefits of VAT to artisan miners, specifically the opportunity to reclaim VAT paid on imports.**

The Small Business section discusses the concept of outreach and education in more detail.

- **Further simplification of the re-fund mechanism for reverse charge VAT on imported services**

See the section on Manufacturing for a fuller discussion of this issue, although it is equally important in the mining sector as regards importing exploration services.

- **Remove tax instruments which discriminate by size of operation in the mining industry**

There are a variety of incentives currently offered to large scale investments which exclude small scale mining operations. (50% initial allowance on equipment and machinery; 0% import duty on raw materials and machinery; 5% flat rate on imports covering import duties, VAT and other charges.)

This is a common problem with tax incentives, as they tend to be biased toward large firms.

Small scale miners should receive the same investment incentives and benefits afforded to larger investments. This will encourage formalization, reduce discrimination and lower the cost of administration.

To reduce the administration costs, this formalization could be facilitated by allowing the co-operatives and importers of machinery and equipment used in the mining industry to apply for these benefits and incentives and then to pass these benefits onto artisan miners.

Manufacturing

Rwanda's manufacturing sector accounts for 8% of GDP and is dominated by the production of import substitutes for internal consumption. Investment in the sector is mostly limited to the repair of existing industrial plants. Larger enterprises engage in food processing (80% of manufacturing output) in particular brewing, as well as chemicals (4%) and textiles (2%). Small manufacturing businesses operate in areas such as agro-industries, leather products, handicraft, and carpentry.

The fragile domestic manufacturing sector continues to face strong regional competition following accession to COMESA in 1994, erratic power supply, and high transport costs. As a result, manufacturing's contribution to GDP has fallen between 1999 and 2004. While accession to COMESA has created opportunities for regional exports, due to the above constraints, manufacturing continues to cater primarily for the domestic market.

Summary of the tax and incentive regime

Corporate Income Tax

The standard rate of corporate profit tax (30%) applies to the manufacturing sector.

As in all sectors, small manufacturing firms with a turnover of less than RWF20 million may opt to pay a 4% turnover tax in place of corporate income tax.

Manufacturing firms benefit from capital depreciation allowances for new capital based on the following annual rates: 50% for computers, 25% for machinery and equipment and other business assets, 10% for intangibles, and 5% for industrial buildings and ancillary equipment.

Value Added Tax

Manufacturing firms pay the standard 18% rate for VAT on imported and locally produced goods, and can claim input tax credits. Capital good imports and exports are zero-rated.

Small businesses can opt-in for VAT registration at any size, but must register for VAT if their turnover is greater than RWF 20 million.

Investment Incentives

Under the new investment code, registered investors may obtain certificates that include exemption from VAT and from import duties on machinery, equipment and raw materials.

Firms in the manufacturing sector, a priority sector under the Investment Code, benefit from a preferential investment allowance of 50 percent (compared to 40

percent for non-priority sectors) if the annual capital investment exceeds RWF 30 million.

Registered firms that operate in a Free Economic Zone will be entitled to (Article 41):

- Permanent exemption from corporate income tax
- Exemption from withholding tax, and;
- Tax free repatriation of profit

In addition, registered firms are entitled to a profit tax discount of between 2-7 percentage points based on the number of employees, and of between 3-5 percentage points based on export value.

The tax and incentive system in practice

While the manufacturing sector is subject to the standard tax regime, the **capital-intensive** nature of the sector and heavy **import dependency** makes taxation (and import duties particularly) a significant burden for firms. Problems in the investment climate are compounded by tax policy and administration (e.g. transport costs and reverse charge VAT).

Income and Value Added Tax

Following reform of the tax code, rates now align well with those in the region. While tax administration has significantly improved, businesses still complain about the lack of consistent interpretation and application of law by tax officials. In addition, in spite of the dearth of skilled labor, requirements are rigid and charges high for employment permits for foreign workers.

Reverse Charge VAT on imported services

Reverse charge refers to the “tax payable by the consumer or importer...on imported services delivered to the consumer in Rwanda by the supplier whose place of business is not in Rwanda” (Article 85). The implementation of the reverse charge VAT for imports of services, such as transportation or management services, has faced some problems. Under Article 29 (VAT Law 2001), “*Payment of tax for imported services shall be made by a consumer by reverse charge*”. This policy aims to ensure that local suppliers who must charge VAT are not disadvantaged relative to foreign suppliers.

For example, when a foreign transporter provides the service to an importer registered for VAT in Rwanda, the reverse charge procedure obliges the importer

to deduct VAT from the payment to the supplier and account for such a retained VAT in the normal way. However in practice, manufacturers are unable to negotiate this reduction in payment, and the VAT is thereby non-refundable (when the input tax exceeds the output tax) and the cost is absorbed by the importer. In addition, manufacturers are in practice unable to find competitive local transporters or management services. In addition, a 15 percent withholding tax applies for management, technical and professional fees.

The government is addressing the above by issuing a ruling that will exempt VAT on imports of international services that can be proved to not be available locally. This is sub-optimal since the burden of proof for a negative lies with the importer. In addition, while services may be available domestically, manufacturers complain that these are not competitive and more expensive than available in the region – as a result, manufacturers face a choice of either paying for more costly local services, or not being able to reclaim VAT if international services are imported – in effect, raising the already high cost of transportation.

In Rwanda, the lack of availability of competitive local services reflects underlying problems in the investment climate, such as poor infrastructure and high energy costs for transportation, and unavailability of local skills. A longer-term approach would be to focus on these root constraints rather than protect less competitive local services and thereby penalize domestic manufacturers.

Box 5. Reverse Charge Mechanism

The most commonly used mechanism for taxing imported services is the reverse charge. The EU introduced a reverse charge in the late 1970s. Canada's GST system incorporates the reverse charge and, more recently, Australia introduced a reverse charge as part of its GST system.

The specific design of the reverse charge can vary between countries but the principle is the same. Registered persons self-assess VAT/GST and claim an input tax credit to the extent that services were acquired for the principal purpose of making taxable supplies.

In New Zealand, the reverse charge generally applies to supplies of imported services that would be taxable if made in New Zealand and that are acquired by a person other than in the course of making taxable supplies. Therefore, if a registered person acquires a service for purposes other than of making taxable supplies, the supply is taxed under the reverse charge mechanism.

In contrast, any services imported and for which the taxpayer is entitled to an input tax credit if the services are supplied onshore are not subject to the reverse charge. This approach removes the necessity for taxpayers to pay Goods and Services Tax (GST) for which they are then fully reimbursed through input tax credits. It also removes the corresponding administrative costs.

The reverse charge mechanism requires registered recipients of supplies of imported services to self-assess GST on the GST-inclusive value of those supplies. For the purposes of the reverse charge, the recipient of a supply will add GST to the value of the services and be required to return the GST as if it had made a supply of the services. This ensures that supplies of services are taxed in New Zealand if they are consumed in New Zealand.

Source: *GST and Imported Goods*, Ch.5: The Reverse Charge Mechanism, Government of New Zealand Discussion Paper, 2001.

Customs and Excise

Manufacturing is particularly disadvantaged by the high cost of transport for imports, which are estimated to be 30-50% higher in landlocked countries (Imani Development, 2005). On average, more than half of inputs are imported (even by small businesses), and primarily from outside COMESA. Taxes levied on imports include duties, VAT, withholding tax and Magerwa (Rwanda Warehousing Company) fees.

Domestic firms regard the 5% import duty on the c.i.f. value of raw materials as too high compared to 0% on the f.o.b. value of raw materials in regional competitor countries (e.g. Kenya, Uganda). Further tariff reductions planned under COMESA will bring Rwanda into line with the region (the target rate for raw materials is 0%). Also, most manufacturing firms do not export and therefore do not gain from allowances such as duty drawback, and zero-rating of VAT for exports.

In addition to the progressive dismantling of tariffs on finished goods, some manufacturers have recently had to contend with significant increases in excise tax on certain products (e.g. 33% on beer).

The Magerwa (Rwanda Warehousing Company) handling fee on imports is a serious concern to the manufacturing sector as it contributes to the already high import costs. Manufacturers consider the 4 percent fee on c.i.f. value of imports as excessively high – of this, 3 percentage accrues to the revenue authorities, and 1 percentage to the Magerwa. The handling charges are based on import value rather than volume and are viewed as hidden duties.

In addition, a withholding tax of 5 percent applies to imports (Article 52), though it is creditable against income tax. These cumulative fees and taxes create incentives for under-valuation of imports and encourage illegal cross-border trade.

Free Economic Zone

Registered investments in the planned Free Economic Zone will be entitled to an indefinite tax holiday which is a sub-optimal tax incentive as suggested by international best practice. For example, since transfer pricing rules do not apply to domestic firms in Rwanda, those which are not registered will try route their profits via internal pricing or service fees to a registered group company. Also, tax exemptions for an indefinite period can create uncertainty and this may only attract ‘footloose’ investors.

Box 6: When Incentives Fail: Lessons from Botswana

In 1980, Botswana introduced its Financial Assistance Policy (FAP), which included a standardized set of incentives as well as more flexible case-by-case incentives, each of which was based mainly on wage subsidies and capital grants related to projected numbers of jobs created. The average grant ranged from \$60,000 for small tourism enterprises to \$2 million for larger industrial projects, most of which was paid in the first five years of a company's operations. The FAP was widely considered instrumental in enabling Botswana to attract a number of significant investments, especially in the textile industry, which created about 6000 new jobs by the early 1990s.

In 1997 Botswana attracted a \$55 million investment in a plant to assemble Hyundai cars and a Volvo trucks which aimed to export most of their output to South Africa, with a small quantity going to other SADC countries. FAP incentives were clearly instrumental in attracting this investment since they were far more generous than those offered by South Africa, the main competitor for the investment. Though the investors cited Botswana's stronger currency and lower basic tax rate, the FAP job creation incentives and wage subsidies for over 1000 workers, together with special duty concessions and other targeted incentives, were sufficient to compensate for Botswana's higher wage rates, lower productivity, and higher transport costs. The job creation subsidies, at R1300 per job, together with the wage subsidy, would have been worth at least R6.5 million in cash grants in the first year alone.

In 2000 Botswana cancelled its FAP. Of the 6000 garment industry jobs created, mainly in the mining town of Selebi-Phikwe, no more than 1500 remained by 1999. The incentives had all been paid out, Botswana's workers were no more productive than before, and the investors had moved on. The Hyundai project collapsed and was liquidated in 2000, with debts of over \$127 million. The main promoter and Managing Director of the project, a Zimbabwean, was subsequently charged in South Africa with crimes including R60 million in customs fraud and R10 million in company theft. The generosity of the FAP incentives was sufficient to attract a shady operator with a project that otherwise made no economic or commercial sense and, in retrospect, the outcome was entirely predictable.

Ironically, an Investment Policy Review conducted by UNCTAD in 2002 found little evidence that the FAP grants were a crucial factor in attracting to Botswana those foreign investors who came and have remained. It seems that the kind of investors that have contributed to Botswana's development would probably have invested even without the incentives, while those who were attracted mainly by the incentives tended to leave the country worse off, both economically and socially, than if they had never come in the first place.

Allowances and Incentives

The major capital incentive provided to the manufacturing sector under the new law is a 50% investment allowance in year one, for investments over RWF 30

million. This significantly lowers the overall manufacturing METR from 17 percent to -7 percent, and the METR on machinery and equipment from 22 percent to -5 percent. This significant benefit accrues to relatively few firms who are eligible.

Under the new law, registered investors operating in a Free Economic Zone are entitled to tax holidays. International experience and research suggests that relative to other types of incentives, tax holidays suffer from major weaknesses, including²⁵:

- Ineffectively targeted, they reward the founding of a company, rather than investment. They also do not reward investment by existing companies – however, extending holidays to companies that re-invest can lead to extending the holiday forever for successful companies.
- They discriminate against investments that rely on long-lived depreciable capital. While holidays may attract footloose industries, they are less likely to attract industries bringing more significant capital commitment. Discouragement of investments with a long-term stake could hurt the economy.
- They can lead to a large erosion of the tax base as taxpayers learn how to escape taxation of income from other sources. When corporate taxpayers have a choice, they have the incentive to shift income into a company enjoying the tax holiday and take more deductible expenses in another company they own and that must pay taxes. They would prefer to have the taxpaying company incur interest costs on borrowed finance and the tax holiday company to be financed with equity. In fact, the tax holiday company could hold debt in the non-holiday company, which can deduct interest while the tax-holiday company earns the interest tax-free.
- Company turnover adds another level of complexity. A company can try to lengthen its holiday term by closing down in one location and restarting, under the guise of new ownership, in another location. Tax authorities may try to guard against such abuses, but it may be difficult to eliminate them entirely.

In practice, most manufacturers are not registered investors (of 185 registered investors less than 20 are manufacturers), so that the tax holiday and incentives under the planned Free Economic Zone will not accrue in significance to this sector, making the incentives redundant.

²⁵ See Table 11

Tax Administration

Unsurprisingly, manufacturing firms consider the late filing and late payment penalties (particularly for small businesses), and interest costs as excessive. Interest costs apply from the date of submission of tax returns and are therefore perceived to be compounded by delays in audits by the authorities. Penalties for late payment are 10 percent of taxable income. The interest liability is set at the inter bank rate offered at the Central Bank plus two percent (interest rates are currently 17 percent) and applied from the due tax payment date. While the delays in audits may be due to lack of capacity in the revenue department, these punitive penalties may be exacerbating the low filing compliance and evasion, especially among small and medium business taxpayers.

Table 11: Relative Pros and Cons of Different Types of Tax Incentives

Advantages	Disadvantages
1. Lower CIT rate	
<p>Simple to administer. Revenue costs are more transparent.</p>	<p>Largest benefits go to high-return firms that are likely to have invested even without incentive. Invites tax avoidance through high-tax enterprises shifting profits to low-tax ones via transfer pricing (intra-country and international). Unlike specific benefits, may not be tax spared by home country tax authorities. Acts as windfall to existing investments</p>
2. Tax holidays	
<p>Simple to administer. Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt).</p>	<p>Invites tax avoidance through the indefinite extension of holidays via creative re-designation of existing investment as new investment. Revenue costs are not transparent unless tax filing is required, in which case administrative benefits are foregone. Attracts short-run projects. Creates competitive distortions between old and new firms. Same as lower CIT rates, except might be tax spared.</p>
3. Investment allowances and tax credits	
<p>Revenue costs are more transparent. Can be targeted to certain types of investment with highest positive spillovers.</p>	<p>Distorts choice of capital assets in favor of short-lived ones, since a further allowance is available each time an asset is replaced. Qualified enterprises may attempt to abuse the system by selling and purchasing the same assets to claim multiple allowances. Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate. Greater administrative burden.</p>
4. Accelerated Depreciation	
<p>All of the benefits of investment allowances and credits. Does not generally discriminate against long-lived assets. Moves the CIT closer to a consumption-based tax, reducing the distortion against investment typical of regular CIT.</p>	<p>Some administrative burden. Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.</p>
5. Exemptions from Indirect Taxes (VAT, import tariffs, etc.)	
<p>Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt).</p>	<p>Prone to abuse-easy to divert exempt purchases to unintended recipients. VAT exemptions may be of little benefit-under regular VAT, tax on inputs is already creditable; outputs may still get taxed at later stage.</p>
6. Export Processing Zones	
<p>Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt).</p>	<p>Typically results in substantial leakage of untaxed goods into domestic market, eroding the tax base. Distorts location decisions.</p>

Source: IMF Conference on Foreign Direct Investment: Opportunities and Challenges for Cambodia, Lao PDR and Vietnam. Hanoi, Vietnam, August 16-17, 2002.

Analysis of the tax regime

The ***overall weighted METR for manufacturing is 17 percent, higher than tourism and agriculture sectors.*** However, the METR on buildings and machinery & equipment is the higher at 22 percent, which is the highest amongst sectors. The primary reason for the higher METR is that depreciable assets used for manufacturing purpose wear and tear more rapidly than those used for other business purposes. Depreciable assets also account for the majority of capital assets used for manufacturing sector. For firms operating in the Free Economic Zone, the METR is zero.

For small manufacturers paying the 4 percent turnover tax and not registered for VAT, the METR is 49 percent, the second highest amongst sectors studied. Because of this tax burden, and a lack of knowledge of compliance requirements, small businesses face incentives to engage in tax avoidance and evasion (under-reporting of turnover and negotiation of turnover tax rates). Small businesses tend not to make use of the opt-in for VAT registration, due to a lack of awareness or not being able to meet the accounting requirements – the METR would fall to 18 percent if small firms registered for VAT.

Recommendations

The overall tax system put in place by recent reforms in Rwanda supports the growth of the manufacturing sector. Possible areas for reform are as follows.

- **Further simplification of the re-fund mechanism for reverse charge VAT on imported services**

Internationally, the reverse charge is a self-accounting mechanism, which involves the importer of foreign services accounting for VAT in their own VAT return. If the business is fully liable for VAT, then the customer can also claim a VAT deduction for the amount charged. Only if the importer is not fully liable, does the reverse charge give rise to a VAT payment. In contrast to Rwanda, in many countries the reverse charge mechanism is required for services imported by registered persons *for purposes other than of making taxable supplies* if the supply of those services by a registered person would be normally taxable supply (see Box 5).

The Australian reverse charge applies to all imported services, while the EU, on the other hand, lists the specific services to which the reverse charge applies. However, the EU is considering the extension of the reverse charge mechanism to all supplies of international services to remove the need to define each type of

service subject to the reverse charge and avoid the need to update the list as new types of services emerge.

- **Reform the Magerwa charge to separate out the import tariff component and the warehousing fee component. The warehousing fee should be applied according to volume rather than value.**

The current Magerwa charge of 4% is a mixture of both a hidden import tax (3%) and a warehousing service fee (1%). It would be more transparent and more equitable to separate these fees and apply them on a basis more in keeping with their purpose. To that end, the 3% import duty component should be incorporated into import duty rates.

The warehousing fee component should be reformed so it is based on volume rather than value. This would better reflect the nature of the service provided. Delays in processing imports through the Magerwa system create problems for all businesses. We are aware that there are on-going efforts by the Government of Rwanda to improve the performance of Magerwa.

- **Move to a system of universal, and less generous, investment allowances.**

International best practice suggests that a low corporate tax rate applicable to all is the best way to incentivize investment. Given that investment incentives are often implemented anyway, Table 11 summarizes the pros and cons of the most popular fiscal incentives. This highlights that discretionary policies are best avoided. Given this, Rwanda should reform the investment allowance system so that all firms registered with tax authorities qualify, but make the allowance less generous (both for revenue neutrality purposes and to ensure that incentives are not overly generous).

- **Review procedures for tax audits to limit time for completion of audits and charge of interest for late payment from date of completion of audit.**

While penalties for inaccurate tax payments are economically justified and sound, business also has a case when it argues that fines and interest payments can be unduly harsh, especially if firms have requested an audit but the delay in on the part of the RRA.

Tourism

In 2005 Rwanda tourism industry is estimated to contribute 3.3% of GDP and generate 47,999 jobs, while the broader direct and indirect travel and tourism economy contributes an estimated 6.5% of GDP and 95,652 jobs. Travel and tourism demand is expected to achieve 12.5% real growth in 2005²⁶ and 5.6% real growth per annum between 2006 and 2015.

The tourism industry is currently focused on primate tours in the Volcanoes National Park, which houses the majority of the last remaining 600 mountain gorillas in the world. Other attractions include Lake Kivu, Nyungwe Forest and Akagera National Park.

The tourism industry is in the early stages of development, having to rebuild from almost zero in 1994. It is difficult to assess the total number of tourists to the country as these statistics are not collected on a regular basis. The only reliable tourism data is that relating to the number of visitors to the national parks. Only 61 tourists visited the national parks in 1994 but this quickly grew to 3,800 by 2000 and to 26,998 in 2004.

The World Travel and Tourism Council (WTTC) provides empirical research on the price competitiveness of countries, as illustrated in Table 12. Regarding price competitiveness Rwanda competes favorably when compared to its immediate competitors and neighboring countries, namely: Uganda, Burundi, Kenya and Tanzania, indicating that overall Rwanda is very price competitive. However when compared to Kenya, Tanzania and Uganda, hotel prices in Rwanda were generally higher than in these countries, possibly due to its land locked nature, heavy reliance on the importation of goods and services and high costs associated with substitute infrastructure.

Table 12: Regional Comparison of Tourism Competitiveness

Description	Rwanda	Burundi	Kenya	Tanzania	Uganda	South Africa	Zambia
Hotel Price Index	19.55	24.55	14.4	14.22	19.21	8.48	17.92
Purchase Price Parity	6.54	7.63	22.52	26.81	7.48	10.46	26.41
Tourism Price Index (2004) ²⁷	12.17	17.85	22.28	26.11	12.73	5.5	29.19

²⁶ World Travel and Tourism Council, Rwanda Country Report 2005

²⁷ '0' shows the least price competitive country and '100' represents the most price competitive country. It is computed using the Hotel Price Index (room rate per night in current (2004) US dollar) and adjusted for Purchasing Power Parity.

The tourism industry is highly fragile, consisting of a large number of small fragmented operators, provides a fashionable and perishable product. It is therefore, very susceptible to global events and suffers from marked seasonality. Tourism in general suffers from inherently low profitability and a high failure rates, especially in the early stages of development. In Rwanda there are various additional factors which impact negatively on the profitability of the sector and significantly reduce its competitive nature relative to other neighboring and regional competitors and the likelihood of success in the industry, such as:

- The tourism industry is young and small relative to competitors, resulting in reduced bargaining power and a lack of economies of scale;
- The limited potential of the high end low volume type tourism in Rwanda;
- The lack of local production increases Rwanda's reliance on imported products;
- High transport costs for both people and products because Rwanda is both landlocked and remote;
- The lack of tourism based infrastructure and the high cost of developing and providing additional infrastructure (generators, water purification and storage plants, road maintenance, etc);
- While Rwanda required high marketing spend to overcome the relatively unknown nature of the tourism products on offer, the actual marketing spend is low.

Summary of the tax and incentive regime

Corporate tax

Corporate tax in the tourism industry is applied at the standard rate of 30%.

As with all sectors, small businesses may opt to pay a 4% turnover based presumptive tax if annual turnover does not exceed RWF 20 million.

Only 40% of expenses associated with electricity, fuel and telephone are deductible for income tax purposes unless sufficient proof is otherwise shown.

Value Added Tax

The standard VAT rate of 18% is applicable to most services offered in the tourism industry. In the law there is provision for exempt and zero rated items. Some of these have been developed specifically for the tourism industry while others are generic, but are applicable to some of the products and services in the tourism industry:

- The transportation of persons by road in a licensed bus or coach, with a seating capacity of fourteen or more passengers is exempt.
- The supply of services which are physically rendered outside of Rwanda is zero rated.
- Transportation by railway is exempt; and
- The supply, by a tour operator or travel agent, licensed as such, to a tourist of an inclusive tour is zero rated.

Based on our understanding, the following are the applications relevant to the tourism industry of the zero rating and exempt supply provisions:

- The local transportation of passengers by road, will be applicable to tour operators, ground handlers, and wheels operators operating vehicles with a capacity of 14 passengers or more. This will apply to: day tours, airport transfers, country tours, chauffer drive services, etc.
- The entire tour package sold to a tourist is zero rated, this includes all aspects of the tour (transport, accommodation and meals, tours, activities, etc). This is also applicable to all tourists who could be international or local and could purchase the tour either inside or outside of the country.

There are restrictions imposed relating to claiming VAT inputs which do have an impact on the tourism industry. A maximum of 30% of the VAT or a maximum of RWF 25,000 can be claimed back on telephone and fuel expenses.

Service charges

Service charges are not compulsory in Rwanda and are left to the sole discretion of the consumer.

Incentives

A number of incentives are provided in the investment code. For registered investors only, the following incentives are applicable to the tourism industry: 28 An initial investment allowance of 50% in the first year of purchasing new or used business assets, which are held for a period of at least 3 years. This also includes vehicles used exclusively in a tourism business. This is however only applicable to investments exceeding RWF 30 million (approximately \$55 000).

- Tourism businesses benefit from zero customs and excise duties on the importation of:

²⁸ Registered Investors are investors who invest a minimum capital equivalent of \$250,000 (international investor) and \$100,000 (local investor) in new business assets and in the expansion, restructuring and rehabilitation of an existing business.

- Tour operator vehicles, hotel shuttles and other specialized vehicles;
- Specialized tourist planes;
- An extensive list of imported equipment used in the hotel and tourism industry, the list covers most equipment used in the operation of a hotel, lodge and casino.
- Registered investors benefit from the employment incentives in the investment act ranging from 2% to 6% for employing between 100 – 200 employees and more than 900 employees respectively.

The industry benefits from the accelerated depreciation rates afforded to all businesses. These state that:

- The construction and reconstruction of buildings is depreciated at a rate of 5% per annum;
- Machinery and equipment is to be depreciated at 25% per annum;
- Computers are depreciated at a rate of 50% per annum.

Duties and Excises

Registered investors in the tourism industry receive extensive benefits in the new law relating to the zero rating of customs duties and excise on the importation of capital equipment, machinery, furniture and other equipment used in the construction and operation of hotels and other businesses in the tourism industry, as aforementioned.

All other businesses in the tourism industry do not benefit from customs concessions or zero rating of customs duties and are subject to the following national rates of customs duties:

Tourism businesses other than registered investors are subject to the following excise duties:

Malt Beer	Wine and spirits	Cigarettes	Petroleum products	Vehicles*
57%	140.52 c/l	60%	37%	15%

**above 1500 cc*

Source: Rwanda Revenue Authority Website "Taxes and Duties in Rwanda"

Visas

Tourist visas are required by all visitors except nationals of the USA, UK, Germany, Canada, Uganda, Tanzania, Kenya, Burundi, Democratic Republic of Congo, Sweden, Mauritius, South Africa and Hong Kong.

Visas for all other countries cost \$60 and can be bought upon arrival.

Airport Taxes

A variety of taxes are levied in relation to air travel, the gazetted airport departure taxes are levied at \$20.

Tax and incentive regime in practice

Corporate Income Tax

The corporate tax rate applied to the tourism sector is on par with competitive destinations in Africa. The only destination, which has a lower corporate tax rate than Rwanda, is Botswana, which has had a CIT of 25% since 1995.²⁹

Small operators forming part of tourism associations, through the associations, are aware of the small business tax regime. A large proportion of these operators are paying some form of turnover tax that is based on a reasonable amount determined by the operator in conjunction with the RRA. Although this is not the true application of the law, the effect is not dissimilar to the prescribed presumptive tax system, which should be based on paying 4% on a reasonable projection of forward income.

The restrictions on deductible expenses have a significant impact on the tourism and hospitality industry which suffer from high fuel costs used with tourist vehicles, airport shuttles and generators required to run lodges and hotels during power cuts. Telephone costs are also a considerable expense, associated with overseas telephonic reservations and revenue associated with telephone usage in guest rooms.

Value Added Tax

In principle the tourism sector benefits greatly from VAT concessions and reductions, however in practice this is not the case.

VAT has a significant impact on the sector. The two main issues relate to how tourism enterprises are interpreting and applying VAT. Many operators gain little benefit from the tax code due to their lack of knowledge and understanding of the tax system and their incorrect application of the code:

- Few operators apply zero rating of VAT to the sale of tour packages;

²⁹ Botswana Department of Taxes in the Ministry of Finance and Development Planning

- Most tour operators pay VAT over to the RRA on tour packages and on their mark-up portion of packages. Some however, due to the price sensitivity of packages, are not charging the VAT onto the consumer.
- Most tour operators were not aware that if they provide a tour operating service to an overseas client, the provision of the service provided by them as long as the client is out of the country, that service is zero rated.

The VAT law is relatively new and most of the above issues, according to the RRA, have not been applied nor challenged by the private sector. There will be therefore, some inconsistency in the interpretation of the laws, until such time as they have been tried and tested. This is especially evident where views regarding the interpretation of the zero rating of the supply of an all inclusive tour differed amongst various parties within the RRA and within the private sector. One reason for this is the ambiguous nature of the wording of this particular article in the VAT law:

- Does the wording “supply of an all inclusive package” refer only to the zero rating of the services supplied by the tour operator and not the entire package? or
- Does it refer to the supply of the package and hence the zero rating of the contents and the entire package which could include (hotel, tour, transport, activities, etc)?

VAT is not currently being applied to the Gorilla permits purchased from the Rwandan Tourism Authority, though there is no reason why this should be so. The supply of the service provided by the Rwanda Tourism Authority, is a service which is provided to people who consume the service whilst in the country and therefore, bar any exclusions, should be subject to VAT.

A large number of small and medium sized hotel and lodge operators, especially those in the outlying areas are not registered for VAT, even though many are above the VAT threshold. According to small and medium operators they have no choice but to buy from unregistered traders and distributors, as the larger distributors do not deliver to their areas. This results in a break in the VAT chain and creates a form of double taxation on VAT.

Operators also tend not to register for VAT as they are unable to charge the VAT onto the consumer due to the highly competitive nature of their sector and price sensitive nature of their service, especially in the rural, outlying areas. The limited number of operators who do register for VAT, tend to absorb the VAT into their profit margin and not charge it onto the consumer. This considerably reduces the profitability of the hotel or lodge placing a considerable strain and burden on the business. It is therefore understandable why these hotel and lodge operators tend to consider VAT a type of turnover tax, levied at 18%.

There is a severe lack of understanding of the VAT system, especially amongst the smaller and more informal operators, resulting in a low buy-in into the system, despite a considerable amount of VAT and tax education by the RRA.

Large taxpayers in the sector complain about the time taken by the RRA to conduct VAT audits and the imposition of penalties and interest. Audits can take up to two years and once completed any penalties and interest payable is then backdated to the date of submission of the tax return and not to the date of the audit.

Withholding tax and reverse charge VAT associated with management fees and overseas based services has an impact on the larger hotels and operators (similar issue as with the manufacturing sector).

The standard VAT rate applicable to certain services in the tourism industry in Rwanda is slightly higher than Rwanda's most direct and immediate competitors (Uganda and Kenya) and also slightly higher than average in the region which is around 17%. (Table 5)

The intention of the law relating to the exemption to transportation was to provide relief for providers of public transport. It was not the intention of this law to benefit the tourism industry, hence the applicability only to vehicles with a carrying capacity of more than 14 passengers. Both Namibia and Uganda go further in ensuring that the intention of the law is not misunderstood and that the law is not incorrectly applied by excluding tourist vehicles from the exemption.

Duties and Excise

Import duties have a large impact on the tourism industry especially on vehicles, equipment and machinery used in the tourism industry, these items are usually imported from Kenya, South Africa or Dubai. However since 2003 the items mentioned in the new investment code relating to duty free importation in the hotel and tourism sector were on a list of duty free items applicable to the tourism industry, which has considerably benefited operators with qualifying investments.

Items imported through the COMESA region are subject to lower duties than items imported outside of the region. Considering that a vast number of items are available in neighboring Kenya this does benefit the industry and reduces the overall burden of customs duties on operators.

Duties and excise do have a significant impact on items in the tourism industry, considering that a large proportion of operating equipment, furniture, fixtures and machinery need to be imported. The increased cost of imports increase the prices in the tourism industry, reduce the profitability and make it more difficult to

compete with countries like Tanzania and Kenya who are far less reliant on imports. Reduction in importation duties especially with regards to hotels and lodge equipment, machinery and furniture and tour operator vehicles will have a significant positive impact on the industry by improving their competitiveness and increasing the potential viability of tourism projects.

Rwanda's land-locked nature adds to the cost of transportation, as does VAT which is based on FOB value, further reducing Rwanda's competitiveness.

Rwanda, in comparison to neighboring countries and immediate competitors has relatively competitive excise rates.

Table 13: Excise Duties in the Region

Country	Malt Beer	Wines	Spirits	Cigarettes	Petrol	Diesel
Rwanda	57%	70%	70%	60%	37%	37%
Uganda	60%	70%	70%	130%	610 c/l	3817c/l
Zambia	70%	125%	125%	115%	60%	30%
Malawi	65%	65%	65%	60%	20%	20%
Kenya	Ksh38/l	45%	Ksh100/l or 65%	0%	Ksh19/l	Ksh8.5/l

Source: Customs and Excise and government departments of South Africa, Malawi, Zimbabwe, Kenya and Tanzania.

Incentives

Only the select few larger operators in the tourism industry currently benefit from the incentives offered in the current tax law.

The drastic increase in the amounts required to qualify as a registered investor from the old law to the new laws (from \$50,000 to \$100,000 for local investors and from \$100,000 to \$250,000 for international investors) is likely to exclude a large number of investors in the tourism industry.

The investment allowances on equipment, machinery and vehicles in the tourism industry do benefit the industry on a longer term basis when businesses move into a profitable situation.

Due to the heavily reliance on the importation of equipment, machinery and capital equipment, in the tourism and hotel sector in particular, the zero rating of the importation of these items for large registered investors provides considerable benefit. Incentives focused on improving the profitability and competitiveness of tourism industries are most effective, especially in young, small and underdeveloped tourism industries and countries.

Visas

Tourist visa conditions in Rwanda are not as restrictive as in other countries like Kenya, Tanzania, Zimbabwe and Zambia, which impose fairly restrictive traveling conditions. Visa costs are however on the high side of the average for the region which ranges from \$30 - \$50. However Rwanda should consider relaxing conditions to other major source markets to Africa, like Germany, France, Italy, Netherlands, etc.

Departure Tax

The amount levied as a gazetted departure tax is in line with Rwanda's neighboring countries and main competitors. Only Malawi, which has recently increased their departure tax from \$20 to \$30 and Tanzania have higher departure taxes than the other countries in the immediate region.

Table 14: Departure Taxes: Rwanda in comparison with the region

Rwanda	Botswana	Mozambique	Kenya	Tanzania	Malawi	Zambia
\$20	\$20	\$20	\$20	\$30	\$30	\$20

Analysis of the tax/incentive regime

The overall weighted average METR on capital in Tourism is 14%, the second lowest among other sectors. This is mainly because the majority of depreciable assets used for tourism business are entitled to a tax depreciation allowance closely matching their economic depreciation rate. As a result, METR on depreciable assets (buildings and machinery and equipment) used by tourism sector is lower than its counterpart in other sectors. In addition the larger businesses in the tourism industry receive considerable benefits relating to accelerated depreciation of business assets and no duty on a vast amount of equipment, machinery, fixtures and fittings used in the tourism industry.

Recommendations

The overall tax system put in place by recent reforms in Rwanda supports the growth of the tourism sector.

Therefore, recommendations focus on improving the competitive nature of the sector by reducing the cost of importation of equipment, fixtures fittings and machinery and by ensuring that VAT concessions are understood and consistently applied by the sector.

- **Hold education and interpretation workshops between the RRA and the tourism associations.**

The issues relating to the interpretation and application of VAT need to be resolved. Currently the private sector is receiving little benefit from these concessions. Education workshops will not only ensure consistency in application but also reduce compliance costs associated with audits, appeals processes and litigation. Although the larger umbrella type private sector bodies have been involved in the development and application of the tax laws this information has not filtered down to the smaller sector based associations. In addition we also recommend that the RRA stress the benefits to the associations and encourage them to encourage suppliers of the industry collectively in order to reduce the price increases created by a break in the VAT chain.

- **Evenly apply the incentives focused on the imports of tourist vehicles and equipment and machinery across the sector**

The impact of duties, excise and transport costs can be considerable and can significantly reduce the profitability of potential future projects, especially in land locked countries such as Rwanda which produce a limited number of items locally. The elimination of export duties on these items across the sector will have a significant positive impact on the sector by increasing the profitability of the sector and improving its competitiveness.

- **Continue to apply the zero rating of tour packages for a limited period**

Apply and monitor the effect of the application of zero rating of inclusive tours in the tourism sector for a limited period.

Consumption, consumer based taxes in the tourism industry can have a significant impact on the profitability of the sector and can result in a significant fluctuation in visitor numbers. Some sectors within the tourism industry are considered to be highly elastic in that a small reduction in price can have a significant negative impact on visitor numbers.

Box 7: VAT on Dutch hotels

In 1969 VAT was introduced at the then 12% full rate on Dutch hotels. The following year was the worst year in Dutch memory for the hotel sector, and the Netherlands tourism balance worsened by 12% in that year. Since 1979 a reduced rate of VAT at approximately one third the full rates has applied to Dutch hotels and restaurants.

Source: World Travel and Tourism Council, Tourism Taxation Striking a Fair Deal, 1998

As a result a number of countries in Europe, Africa and South America currently apply a lower rate of VAT or VAT exemptions to the restaurant and accommodation sectors, such as:

- Africa: Kenya (standard 16%, reduced 14%)
- South America: Chile and Columbia allow the deduction of VAT on all services provided to foreign tourists
- Europe: Belgium (Standard: 21%, Reduced: 6%), France (Standard: 19.6%, Reduced 5.5%, Greece (Standard: 18%, Reduced: 8%, and Ireland (Standard: 21%, Reduced: 13.5%), Portugal (Standard 21%, reduced 5%

The argument for a reduction in VAT in the tourism sector and the zero rating of overseas tour packages can usually be justified in highly elastic tourism sectors such as packaged beach holidays and safari destinations where a small change in price can result in tourists moving to a competitive or comparative destinations elsewhere around the world.

Box 8: Elasticity of demand in the tourism sector

A Deloitte and Touche study conducted on behalf of the British Tourist Authority determined that the price elasticity of the holiday tourist market was -1.5 – that is a price cut of 10% would cause a 15% increase in the volume of tourist demand.

Source: WTTC “Tourism Taxation – Striking a Fair Deal” 1998

Rwanda is one of only three countries in the world, along with the DRC and Uganda which offers the opportunity to see the last of the mountain gorillas in their natural habitat. In addition all countries impose heavy restrictions on visitor numbers, (40 in Rwanda and 16 in Uganda) resulting in a very limited and finite market. Due to the restrictions on the number of visitors allowed and the uniqueness and exclusivity of the experience extremely high prices can be commanded, indicating the inelastic nature of this sector of the industry.

Rwanda’s future growth in tourism numbers is also unlikely to come from “Gorilla trekking” based tourism, due to the restrictions imposed on the numbers of gorilla permits available. Rwanda therefore needs to look at other ways of growing their tourism industry. One way of unlocking the future potential of the tourism industry is to increase the current average length of stay of 2-3 days by encouraging tourists to visit other areas of the country and not only the Volcano National Park. The experiences in these areas are not as exclusive and unique as the Gorilla trekking experience and are therefore likely to compete with similar

³⁰ HOTREC updated on 1 June 2005

and substitute products in neighboring countries. The zero rating of VAT on package tours, assuming that prices are reduced accordingly, will help encourage tourists to visit other areas of the country.

Although Rwanda's tourism industry has recorded relatively significant growth it is still at a very young and under-developed stage with a very low base of tourist numbers and is yet to reach its full potential. Tourism industries in developing countries are faced with additional burdens associated with: poor infrastructure, high duties and excise costs, low productivity of staff, unskilled labor, high cost of capital, etc all of which result in a reduced profit margin and push up prices to the point where the operations become barely feasible.

Box 9: Returns on international marketing spends

The British Tourist Authority estimates that every £1 of government spend on tourism marketing results in £25 spend on tourism.

Source: World Travel and Tourism Council, Tourism Taxation Striking a Fair Deal, 1998

- **Remove visa requirements in major source markets such as Germany, France, Italy, Netherlands, etc and reduce visa costs to \$30 to encourage tourism**
- **All proven expenses associated with fuel and telephones should be deductible for income tax purposes**
- **Impose VAT on gorilla permits issued by the ORTPN**

It is recommended that VAT be imposed on gorilla permits as a service based and consumed in the country.

Due to the uniqueness and exclusivity of this type of tourism an increase in price is not likely to have a negative impact on the number of visitors. Especially considering that in the past large price increases have had no effect on visitor numbers, which continue to increase.

- **Investment allowance should apply to all investments**

As in other sectors, the initial investment allowance of 50% on hotel buildings should be extended to all investments in the tourism sector and not just large investments. This incentive is consistent with regional competitors and should apply to the entire sector and not only to large investments. In doing so this will also encourage formalization and will reduce the cost associated with compliance and administration.

Financial Sector

Rwanda has a fledgling financial sector. In all key markets (banking, pensions and insurance), there are few providers, few products and a limited customer base. However, this situation is changing and legislation and taxation reform will play an important role in driving growth in this critical sector.

In September 2005 the IMF released its ‘financial system stability assessment’ for Rwanda. The assessment concluded that economic activity in the country is concentrated in only a few sectors, and that banks compete for deposits and loans from only 50 corporate customers. Around 30% of households have access to a financial institution, which is good for a country at Rwanda’s stage of development, but the overall credit culture is weak, with agriculture receiving only 2% of loans despite being the largest sector in the economy. Non-performing loans constitute about a third of the total, because of weak credit analysis by banks and the slowness of the legal system in forcing people to repay their debts.

The assessment noted with approval that five of the country’s financial institutions had been re-capitalized recently, two via privatization, improving the financial solidity of the sector, but warned that, with foreign aid agencies and other international bodies responsible for about 30% of deposits (mostly in US dollars), the financial sector would not cope well with a prolonged decline in foreign aid.

Summary of the tax/incentive system

Corporate Income Tax

Banks

There are six licensed commercial banks, a development bank and two cooperatively owned finance institutions. There are also over 100 micro-finance institutions, of which the Reserve Bank has only licensed eight.

Banks pay the standard 30% rate for corporate income tax. Commercial banks primarily earn revenue from international exchange transactions and the purchase of government securities. Business lending is still in its infancy and there are a limited number of bankable projects.

The new law provides for a corporate income tax of zero for micro-finance institutions, as designated by the Reserve Bank, for a period of five years (Article 42).

Insurance / Pensions

Insurance companies also pay the standard rate of corporate income tax. The new law moves the treatment of pensions to an 'E/E/T system', where-by pension contributions (from both employers and employees) are tax exempt, pension fund returns are exempt from corporate income tax, but pension payments are taxable as personal income.

Value Added Tax

Banks: Fees on personal current account activities are exempt from VAT.

Insurance / Pensions: The premiums charged on the provision of life and medical insurance services are exempt from VAT.

These are the only two exceptions and otherwise VAT applies uniformly to the financial services sector.

Withholding taxes

The new tax code lowers the withholding tax on interest income from 20% to 15%, but extends the tax to dividends, royalties and management fees. These payments are however, creditable against corporate income tax (Article 51, new tax code).

The Tax / Incentive Regime in Practice

Banks

As personal account fees are VAT exempt, banks bear an effective sales tax burden on their inputs to this portion of their business. However, as personal account fees currently generate a small proportion of banks' revenue, this exemption is likely to have less of an impact on the METR than with insurance (see below).

It will be interesting to evaluate whether the zero rated corporate income tax for micro-finance institutions leads to a sustained expansion in micro loans. The new law assumes: (a) there are many profitable projects that the current banking system is simply unwilling or unable to support; and (b) that the elimination of corporate income tax will lower the price of micro-loans. ***It is not a-priori evident that these assumptions hold or that exemption from corporate income tax will achieve an expansion of sustainable micro-credit.***

Commercial banks will not be able to claim a pro-rata tax deduction for any micro-finance business they undertake, and so will face no incentive to do so. Further, the perceived need for zero corporate income tax signals to the traditional banking sector that this market is unprofitable.

This provision is in direct contrast to the incentives available to very large investments under the investment code. This dichotomy creates the appearance of confusion within the Government of Rwanda's strategy for economic development, promoting both very large *and* very small investors.

That the period of zero corporate income tax is set at five years is welcome, and provides a useful opportunity to review the impact of the tax holiday. However, the tax code leaves the door open for renewal by order of the Minister. This creates incentives for lobbying, and – if extensions are granted - will lead to micro-finance institutions becoming dependent on this subsidy.

Insurance / Pension

The treatment of pensions under the new tax code is welcome as it is more likely to promote savings and may help to restrain wage inflation (given the myopic nature of most employees).

However, the specific exemption from personal income tax provided to pension payments from the state social security system (*vis-à-vis* private pensions) appears inequitable and inconsistent.

The premiums charged on the provision of life and medical insurance services are exempt from VAT. In the case of life insurance this is consistent (as buying life insurance is effectively saving not expenditure) but less so for medical insurance. All other insurance transactions are subject to VAT. A rough estimate of the contribution of life insurance to the total insurance revenue in the sector is 40%.

This new lower rate for withholding taxes, together with the fact that withholding taxes are creditable against income tax, should incentivize savings. The new rates are comparable to those in the region.

Other Issues

Leasing (operating or capital) provides a very useful way for low-income countries to increase investment. A capital lease (where the lessee owns the asset) is a form of secured lending. There is no current leasing market in Rwanda but several of the commercial banks are actively investigating the opportunities.

Box X outlines some of the lessons learned from the development of the leasing market in emerging economies. A key issue is how to tax leases, in terms of import duties on the capital, depreciation allowances and the application of VAT.

Currently, due to a lack of alternative legislation, RRA's position is that both the interest and principal portions of capital lease payments are VAT-able. This is understandable (RRA are applying the VAT legislation as they view it) but unfortunate as it puts capital leases at a disadvantage to a similar transactions structured as a loan to purchase an asset (when the interest payments would not be subject to VAT).³¹ ***Equal treatment would help stimulate the capital leasing market in Rwanda.***

The new tax code will not allow the expensing of interest on foreign exchange denominated loans. This move will artificially support the local bank lending market and restrict a flow of potential finance for domestic firms. This is especially a problem for exporting companies wishing to match their finance and revenue currencies. That this applies only to interest expense over and above loans charging LIBOR+1% reduces significantly the potential impact of this legislation, but also reduces its relevance.

Banks benefit from bad debt allowances, which are more generous than those available to other sectors. This is primarily because of the reserve requirement for the non-performing loans. Firms with a significant amount of unrecoverable debt have a legitimate concern that formal bankruptcy in Rwanda is too long a period to be carrying bad debt. It would appear equitable that the RRA and the business community come to an agreement where-by loans are classified as 'extremely unlikely to be ever collected', and allow these loans to be expensed without having to wait for formal bankruptcy.

³¹While it is true that VAT-registered businesses would be able to credit these VAT payments; (a) not all businesses are VAT registered, (c) some firms are engaged in Vat exempt activities (such as transport), and (b) it creates a cash flow problem, especially for small businesses.

Box 10: International Best Practice on Taxation of Leasing

In April 2005 the International Finance Corporation published a document on best practice regarding how to expand the leasing market. The highlights are:

Incentives for the leasing sector, if any, should be moderate as the over endowment of preferential tax treatments on leasing may cause distortions in domestic markets, and ultimately a negative effect on the general financial sector. The main reason to provide preferential treatment should be to increase domestic investment, and not stimulate the leasing sector.

The report provides the pros and cons of removing VAT on the import and/or sale of equipment intended for leasing. The tendency is to either make all steps VAT-able or VAT-exempt, rather than a mix, in order not to break the VAT-chain.

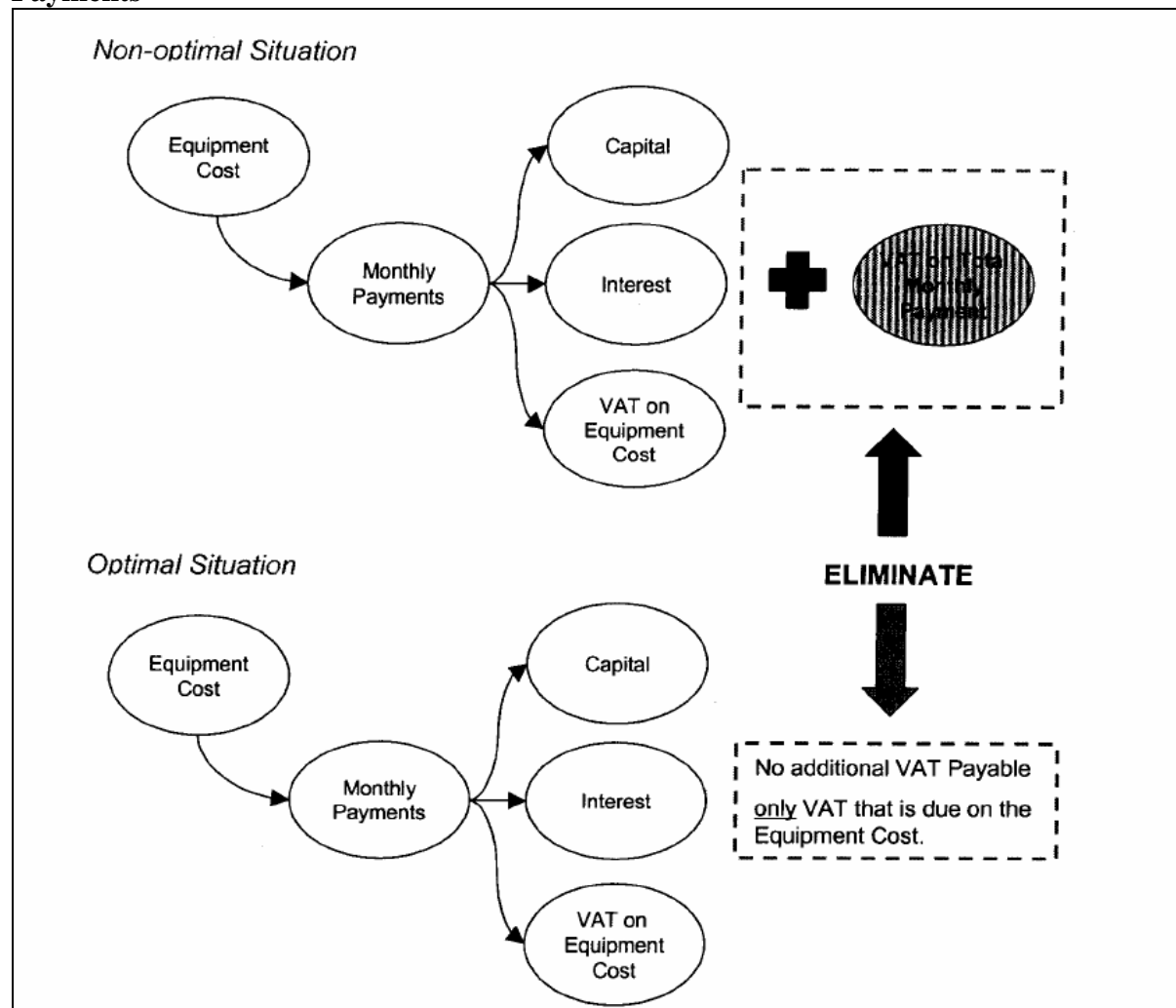
With capital lease payments the IFC recommend that *“There should be a level playing field in terms of the tax effects of domestic credit offerings and leasing should not be disadvantaged against other forms of credit.”* Therefore, the interest portion of capital lease payments should be VAT exempt, as are interest payments for normal bank loans (see Figure 1).

In terms of deductible expenses against revenue, again, IFC recommend a level playing field vis-à-vis a traditional loan (used to purchase an asset). i.e. that both the depreciation and interest component of lease payments are deductible for income tax purposes. In terms of depreciation, IAS-17 is clear on whether the lessee or the lessor can claim ownership for a capital or operating lease (and the definition of these two terms). It is possible (but not advisable) to offer more favorable, accelerated, depreciation rate for leased vs. traditional procured assets.

Source: Leasing in Development: Lessons from Emerging Economies, International Finance Corporation, Washington D.C., April 2005.

The treatment of capital gains as normal corporate income in Rwanda provides a simple regime that is easy to administer. Over time however, the taxation of capital gains at 30% may act as a disincentive on corporate finance activity. Most emerging market economies (such as South Africa) have a capital gains tax rate lower than the rate for corporate income.

Figure 1: The IFC’s Proposed Treatment of VAT for Capital Lease Payments



Source: Source: Leasing in Development: Lessons from Emerging Economies, International Finance Corporation, Washington D.C., April 2005.

Analysis of the Tax Regime

With an overall weighted average METR on capital of 38%, the financial sector bears a marginal tax burdens on capital that is highest among other sectors studied. This is mainly because of the VAT exempt status on many financial activities. Financial services are one of the few sectors not designated a ‘priority sector’ by the new investment code and so do not benefit from these incentives.

Recommendations

- Change the tax treatment of leasing transactions. Specifically:
 - The VAT Act needs to state clearly that leasing is classified as other financial service products therefore exempt from the interest portion;
 - Provide guidance on VAT treatment throughout the chain – from supplier to the lessee;
 - Clarify the current tax treatment of leasing transactions. It is assumed that the lessors will be allowed to claim the capital allowances while the lessee is able to deduct the full lease rental.
 - Harmonize the application of withholding tax within the East African region so as to promote cross border leasing.
 - Allow for leased assets to qualify for incentives provided for by RIEPA in case of eligible lessees.

These reforms would make capital leases comparable to loans, which is consistent with international best practice.

- Carefully evaluate the impact of the 0% corporate income tax on micro-finance institutions.

This is important to test whether it has led to a sustainable expansion of small loans, over and above that which would have occurred under a standard corporate tax regime.

- Allow the expensing of debts which are extremely unlikely to be collected, rather than relying solely on formal bankruptcy procedures.

This point relates to all businesses, but is raised here as it comes to light in direct contrast to banks, which enjoy the opportunity to write off ‘bad debts’ whereas other businesses do not.

- Review the relevance and necessity of Article 22, regarding the expensing of foreign exchange denominated loans, with a view to removing it.

It is unclear why this legislation exists, and what is its intended effect.

Small Business Sector

A recent study estimated that there are nearly 70,000 micro and small scale (MSSE) enterprises in Rwanda (defined as turnover of less than RWF 15 million

per annum).³² However, only around 1,000 small businesses are currently registered with the tax authorities (defined as turnover less than RWF 20 million in the New Law). This indicates that most small businesses are registered at the local government level, or operate outside the formal sector.

Description of regime

Under the small tax regime, small businesses with an expected turnover of less than RWF 20 million (RWF 15 million in the Old Law) may opt to pay a presumptive tax of 4 percent of turnover or can opt to pay the standard corporate income tax of 30%. Small businesses are not required to register for VAT, but can opt-in at any level, so as to benefit from input tax credit.

Many businesses operate as sole proprietors and therefore pay personal income tax rates of either 0, 20, or 30 percent.

Small businesses are liable for all other national and municipal taxation (import duties, PAYE, etc).

Tax System in Practice

Income Tax

Most small businesses tend to opt for the presumptive regime instead of the general system. Although this simplifies tax administration, it does not contribute to creating or strengthening a culture of compliance among small businesses. Even when informed and profitable small businesses opt for the corporate income option, in practice they may be unclear about the nature of expenses that qualify for deduction from taxable income (even though the new law lists these items).

As many small businesses in Rwanda are sole traders, they are in effect taxable under the personal income tax regime: exempt for income up to RWF 360,000, 20 percent between RW 360,001-1,200,000, and 30 percent above 1,200,001. This means that they face an effective tax rate of 0-30 percent.

Small businesses are also required to withhold PAYE and dividend tax. However, given their small size and their difficulty to maintain proper accounting records there is a great incentive to underreport turnover as well as to arbitrage between salaries and dividends. The tax burden is compounded by taxes and fees at the municipal or district levels which tend to be significant for small business.

³² Review and Assessment of Micro and Small Scale Enterprises (MSSEs) in Rwanda, World Bank, May 2004.

Box 11: Promoting Tax Graduation

A major flaw of most special regimes is that they do not include explicit plans for “growing” taxpayers out of the special system into the normal system of taxation. This increases the potential unintended impacts of special regimes and hinders the success of a special regime in achieving its stated goals. A few countries place limits as to the number of years that a taxpayer can be taxed under the alternative presumptive scheme. But very few countries set the tax levels or rates of the imputed system high enough to encourage taxpayers to “move on” to the regular tax system. On the contrary, the political economy of presumptive systems almost guarantees that the tax burdens enjoyed by those in such regimes are sufficiently favorable to make them an attractive place to stay and provide no incentive to graduate.

In principle, a country may choose to phase out eligibility of specific taxpayers, for instance, by establishing a limited period of eligibility for a simplified system, or it may phase out the presumptive tax system entirely. If “taxpayer education” – bringing taxpayers up to the point at which they can enter the regular system -- is an important goal of the special regime, those in that regime might perhaps be assumed to graduate automatically after a certain number of years. Or all those in the system might be required to re-qualify – to demonstrate that they are still incapable of coping with the normal system -- by being subject to a special audit every five or ten years. It is important to avoid taxpayers hiding themselves forever within an unduly favorable simplified system, as happens in many countries.

Graduation can be facilitated by some version of the Japanese (and Korean) system of awarding certain fiscal privileges, such as depreciation of assets and access to tax incentives, only to those who enter the regular tax system (Kelley and Oldman, 1973). Much the same effect can be achieved by the popular device of “tax clearance certificates,” required in many countries to obtain other documents such as passports, liquor licenses, etc. This treatment may, however, sometimes be considered too discriminatory against truly “small” businesses, or may be thought to give too much scope for officials to harass taxpayers.

Source: Extracted from “Is it really so hard to tax the hard-to-tax? The context and role of presumptive taxes”, Bird and Wallace, 2003.

VAT

While small businesses are not required to register for VAT, staying out of the VAT net may be more of a tax burden than paying the tax. Non-registration often creates breaks in the VAT chain resulting in small businesses not being able to claim back VAT on inputs. Small businesses therefore may suffer a substantive

VAT burden. However, in order to enter the VAT net, to meet reporting requirements a taxpayer must submit monthly reports. This is well beyond the capacity of most small businesses.

Box 12: An argument for small enterprises “opting-in” to a VAT regime, despite compliance costs

There are important circumstances in which it is commercially advantageous to be fully liable for VAT. This includes firms selling zero-rated items and those selling to other firms registered for VAT in order to reclaim tax paid on inputs. For these reasons, it is common to allow firms to register for VAT voluntarily. The right is subject, typically, to provisions guarding against temporary or fraudulent registration simply to obtain refunds: deregistration is commonly restricted, for instance. Indeed, there is a sense in which a reduction in the threshold is self-enforcing: the more firms that are subject to VAT the greater the likelihood that a trader will find themselves selling to registered traders and so will find it advantageous to register too.

Even when it is commercially advantageous to be below the threshold, however, the extent of that advantage should not be overstated. Small traders will be unable to recover VAT on their inputs: it is only their own value added, not the full value of their sales, which escapes taxation. Nevertheless, there clearly is potentially some cause for concern. In particular, firms characterized by a high ratio of value added to sales and selling to unregistered purchasers—small traders providing services directly to final consumers being the key group here—are likely to find it worthwhile to be exempt from VAT. Thus equity considerations would tend to point toward higher thresholds than would otherwise be the case.

Source: Ebrill, Keen, Bodin, and Summers, The Modern VAT, IMF, 2001, p. 120.

Box 13. Registering Potential Taxpayers

Most reforming countries allot a unique Taxpayer Identification Number (TIN) to existing and potential taxpayers. In some countries, like Jamaica, appropriate legal provisions have been made to make the use of the TIN mandatory in transactions with tax authorities, for obtaining various licenses and permits and for significant economic transactions that have tax implications. This forces potential taxpayers to come to revenue administration and register.

Source: Extracted from “The Nuts and Bolts of Revenue Administration Reform”, J. Gill, World Bank, 2003.

Cost of compliance

Small businesses perceive the tax system as incurring high time and financial cost and thus may not see any incentive to join the tax net even if they could. Small businesses face an ‘inverse economies of scale’ impact of paperwork and procedures required for tax authorities (see Blazic 2004).

Presumptive turnover tax can simplify tax administration and compliance costs and hence benefit both tax administrators and taxpayers. However, a high presumptive turnover tax, may play a negative role by encouraging small firms to avoid paying the tax via under-reporting of gross revenues causing additional revenue authority auditing³³. This interaction may form a vicious circle, and lead to an unhealthy tax environment that encourages expansion of the informal economy.

The most recent Doing Business report shows that Rwandan companies are required to pay 42 different taxes. Although the new tax code will reduce this figure, the RRA need to continue to work to bring down this number that will greatly help reduce informality.

³³ While businesses could opt for the standard corporate income tax system, in practice many may be unable to meet the accounting requirements.

Box 14: Fostering Voluntary Compliance

Voluntary tax compliance does not have a strong history in many developing countries. Encouraging it is a major challenge, which has involved efforts in three directions (both for small and large taxpayers). First, various activities, often quite creative, have been undertaken to make potential taxpayers aware of the general concept of taxation and why they should pay tax. Revenue administrations have organized awareness raising campaigns involving TV and radio programs, competitions to create advertisements displayed on buses, and school plays on tax issues. Some administrations have also sought to incorporate tax themes in school curricula, in collaboration with Ministries of Education

Second, efforts to make compliance easier for taxpayers. This consists of publishing pamphlets and creating web pages giving out information on tax laws, rules and procedures and changes thereto; organizing seminars and workshops for taxpayers, providing assistance to taxpayers in filling up tax returns, looking up their accounts to see how much they owe and clarifying doubts on legal and procedural matters; setting up telephone hot lines to answer questions; appointing floor walkers to assist taxpayers waiting in queues; and keeping tax offices open for longer on days when there are declaration filing deadlines.

The lack of an adequate number of private sector firms specializing in tax advisory work is a major drawback in most countries, especially in transition economies. Although large taxpayers usually have access to local branches of international accounting firms and some local firms, the small and medium taxpayers as well as individuals, generally, do not have this facility. This puts pressure on the revenue administration to double up as a tax adviser. For instance, the Volgograd tax administration in Russia has created an advisory service run by current and retired employees, who help taxpayers prepare returns and face audit queries, for a small fee. A Chinese wall exists between the advisory and administrative branches of the tax administration, but the potential for conflict of interest in this arrangement is obvious. Efforts are also being made in Russia to create and strengthen Taxpayer Associations and to catalyze the establishment of a tax advisory services profession.

Source: Extracted from "The Nuts and Bolts of Revenue Administration Reform", J. Gill, World Bank, 2003.

Lack of outreach and capacity building of small entrepreneurs

Revenue Authorities face an incentive to focus scarce resources on large taxpayers rather than small taxpayers, as the cost of monitoring and collecting tax from

small businesses usually outweighs revenues generated. Like many countries, Rwanda has established a Large Taxpayer Department (LTD). The Internal Revenue Department (IRD) serves small and medium businesses (see Box 2).

The Rwanda Revenue Authority has one of the most effective programs of community information dissemination in the region. However, it does not have an outreach program for small businesses with the aim of building a ‘culture’ of tax compliance. Tax compliance and recording requirements are often strong deterrents to registering a business and paying taxes. In addition many small firms do not have enough information to be able to enter the tax net even if they had the desire and necessary skills to do so.

This deficiency may be partly addressed through the launch of the joint public-private initiative of Business Development Services (BDS) centers. The centers will serve SMEs, cooperatives, MSSEs and entrepreneurs by offering information, training, access to financing facilitation, networking and consulting services. These centers are a good venue for training on financial accounting practices, as well as facilitating the process of formalization by providing information and training on tax registration.

Box 15: Small Taxpayer Department

A small taxpayer department (STD) would have several critical tasks, none of which seems to be well done at present in most transitional or developing countries. For example, a good small taxpayer department should make the life of small taxpayers easier than it would otherwise by reducing the opportunity for official harassment and the complexity of tax rules. It should also make the life of tax officials easier (if not necessarily more financially attractive) by establishing indicators that can easily be verified. More importantly, its aim should be to make the tax system as a whole more efficient and equitable by estimating carefully the income (or sales) imputed on the basis of such indicators and ensuring that the indicators are periodically adjusted to reflect changing conditions. Finally, for the health of the tax system as a whole, the STD should ensure both that those in the small taxpayer system keep at least minimal records and that they are periodically reviewed and upgraded as appropriate in both record-keeping and the extent to which they are in the regular system, until full graduation.

Source: Extracted from “*Is it really so hard to tax the hard-to-tax? The context and role of presumptive taxes*”, Bird and Wallace, 2003.

Recommendations

Rwanda has a special tax regime for small business which, if further simplified, would encourage increased compliance. Main objectives of a small business tax regime should include³⁴:

- To create a “culture of taxation” and the regularization of the rule of law
- To provide education and training on how to monitor business activities
- To increase the size of the formal sector
- To promote growth

In view of the above objectives, Rwanda could consider the following measures to improve the small tax regime.

- **Continue to investigate ways to bring down the number of taxes paid.**

Accepting that the new tax code simplifies the tax regime significantly, the Doing Business metrics provide a useful way to tracking progress on simplifying the tax code – which is especially beneficial to small businesses.

- **Consider reduction of turnover tax rate to 3 percent from 4 percent to encourage more small firms increase tax net.**

The METR and qualitative analyses suggest that the current 4 percent rate of turnover tax is high and may be a deterrent to widening the tax net in Rwanda. A tax regime for small businesses should be low enough to encourage participation but not so low that it allows for tax evasion by larger firms. International best practice suggests that a special tax regime for small enterprises should offer reduced compliance costs and a reduction in the actual tax burden. This reduction in the actual tax burden is intended both to compensate for the difficulties that this sector faces in accessing capital and to act as an inducement to enter the “formal sector”.³⁵

- **Revise VAT reporting requirements from monthly to quarterly returns.** This would help low capacity small businesses to comply with tax administration monitoring, while still providing the RRA with a regular stream of income.

³⁴ Stern and Barbour, 2005.

³⁵ For small businesses, participating in a tax regime brings a firm into the formal sector, and allows the firm to access formal credit markets, government procurement, and access to markets.

- **Review of VAT penalties and interest due for late payment as these are excessive for small businesses.** While the levels should be set so to enforce compliance, they should not represent a disproportionate financial burden. One option being explored in Rwanda to increase compliance is requiring tax registration for renewal of licenses (Box 4).
- **Enhance role of the RRA to include outreach and education for small businesses.** The revenue authority could consider expanding its mandate to include capacity building and training on business accounting practices with a view toward helping firms graduate to the standard tax regime (Box 5). Such training should be seen as an investment for the tax authority because as the firm grows, it will be likely to pay more taxes.
- **Continue to investigate ways to simplify standard tax regime to help small businesses (see sector recommendations also).** International best practice suggests that a simplified general tax system benefits small businesses (Golab, 1996). First, the compliance costs for such general tax system are lower and this benefits small firms disproportionately. Second, as tax incentives tend to benefit larger, better connected and more influential firms more, their elimination allows the introduction of a lower rate flat-tax, which benefits smaller firms. Third, increases in personal tax exemption especially benefits small businesses as many operate as sole-proprietors.

Comparison with Neighboring Countries

For purposes of comparison, this section provides extremely rough estimates of the METRs on capital income in the neighboring countries of South Africa, Malawi, Tanzania and Zimbabwe. The METRs are calculated for the general tax system in each of these countries and reflect only provisions available either to all firms or to all firms within one of the sectors analyzed in the report; that is, the report does not consider incentives granted to specific firms within a sector (such as selective tax holidays, which are prevalent in all of the comparison countries) or to other categories of firms such as exporters or firms in tax-favored regions. Since the treatment of mining appears to be relatively idiosyncratic, the comparison examines the tax treatment in the other four sectors – manufacturing, tourism, agriculture and financial services. Table 12 below presents a schematic overview of the tax and incentive schemes in each comparator country.

METR Results

The comparison of METRs in Rwanda with those in the neighboring countries of South Africa, Malawi, Tanzania and Zimbabwe are presented in Tables 5-18.

Table 15. Comparison of METR Calculations in Agriculture

	Rwanda	South Africa	Malawi	Tanzania	Zimbabwe
Machinery	11.9%	22.6%	17.3%	18.2%	6.6%
Buildings	0.9%	n.a	-12.4%	10.5%	-46.5%
Land	4.5%	32.0%	-2.2%	20.7%	-39.7%
Inventories	24.1%	40.5%	18.9%	33.3%	56.4%

Table 16. Comparison of METR Calculations in Tourism

	Rwanda	South Africa	Malawi	Tanzania	Zimbabwe
Machinery	-11.1%	25.1%	7.2%	9.4%	-2.4%
Buildings	-1.3%	29.8%	-12.4%	10.5%	-46.5%
Land	7.5%	32.0%	-2.2%	20.7%*	-39.7%
Inventories	51.6%	43.3%	22.7%	36.5%	58.5%

*Does not include land tax, which results in METRs well over 100 percent.

Table 17. Comparison of METR Calculations in Manufacturing

	Rwanda	South Africa	Malawi	Tanzania	Zimbabwe
Machinery	-11.1%	25.1%	7.2%	9.4%	-2.4%
Buildings	-1.3%	29.8%	-12.4%	10.5%	-46.5%
Land	7.5%	32.0%	-2.2%	20.7%*	-39.7%
Inventories	49.2%	43.3%	18.9%	33.3%	56.4%

*Does not include land tax, which results in METRs well over 100 percent.

Table 18. Comparison of METR Calculations in the Financial Sector

	Rwanda	South Africa	Malawi	Tanzania	Zimbabwe
Machinery	29.9%	44.2%	7.5%	34.0%	20.6%
Buildings	-0.9%	29.8%	16.2%	14.6%	-27.6%
Land	9.7%	32.0%	18.6%	20.7%*	-39.7%
Inventories	59.5%	40.5%	43.9%	33.3%	56.4%

*Does not include land tax, which results in METRs well over 100 percent.

These results suggest that METRs in Rwanda compare favorably with those in the neighboring countries of South Africa, Malawi, Tanzania and Zimbabwe. METRs in Rwanda are generally lower than or roughly similar to those in the comparison countries, except for investment in inventories in countries with lower rates of inflation and some investments in Zimbabwe. However, METRs in Zimbabwe are relatively low (for assets other than inventories where the FIFO accounting results in taxation of inflationary gains) not because the tax system is more generous than

in Rwanda but because the inflation rate is so high (over 50 percent) – not an example Rwanda would want to emulate.³⁶ And, as noted above, METRs on investments in inventories in Rwanda would be reduced dramatically if firms chose the LIFO inventory accounting system. Thus, it seems that the tax component of the investment climate in Rwanda should not be a significant barrier to investment, relative to the tax systems of neighboring countries.

More specifically, METRs in South Africa are generally higher than in Rwanda, primarily due to the secondary tax on companies, somewhat less generous depreciation deductions for machinery, and no investment allowance for buildings, and the imposition of a relatively high property transfer tax. However, inventories are taxed somewhat less, solely due to a lower rate of inflation (6 percent) and thus a lower rate of effective taxation of inflationary gains on inventory.

Similarly, METRs in Tanzania are generally somewhat higher than in Rwanda, except for investment in inventories which is effectively taxed less heavily since the inflation rate is relatively low (4.4 percent). The higher rates in Tanzania primarily reflect somewhat less generous depreciation deductions for machinery and a smaller investment allowance for investment in buildings. Note that the effects of the land tax in Tanzania are not included in the METR calculations. If the land tax were effectively enforce at a rate equal to around 12 percent of market value, the METRs in investment in land, in sectors other than agriculture, would be well in excess of 100 percent. Although taxes on land have long been supported on both efficiency and equity grounds, effective tax rates in excess of 100 percent would certainly be extreme.

The METRs in Malawi reflect the effects of the 10-year tax holiday regime available for investments in manufacturing, tourism and agriculture. As noted in the discussion of potential tax holidays in Rwanda, the effects of such holidays are difficult to predict, since the benefit of the zero tax holiday rate and the lower future tax rate are offset by the loss of generous accelerated deductions and up-front investment allowances. The tax holidays in Malawi is, however, generous as they extend (at least in the case analyzed) for ten years and are then followed by a preferential income tax rate of 20 percent. The net result is that for manufacturing, tourism and agriculture, the METRs on investment in machinery and buildings are roughly similar to those for Rwanda (where deductions for depreciation on machinery and the investment allowance for buildings are fairly generous) and

³⁶ A high inflation rate results in low METRs at the firm level because interest expense, including the inflationary component, is fully deductible. Note that the low METRs in Zimbabwe are illusory to the extent that the inflationary component of interest income received by the owners of debt is also subject to tax.

lower for investment in land and inventories, where the depreciation deductions and investment allowances are irrelevant in determining effective tax rates and the 20 percent post-holiday income tax rate plays an important role in lowering METRs. Note that the financial services sector does not receive a tax holiday in Malawi. In this sector, relative to the effective tax rates in Rwanda, the METRs for Malawi are lower for machinery, reflecting primarily the very generous 40 percent investment allowance, higher for buildings, reflecting primarily the absence of an investment allowance for commercial buildings; METRs in the financial services sector are also higher for land but lower for inventories, primarily due to the differences in inflation rates between the two countries.

Finally, it is worth noting that METRs in developed (OCED) countries are not necessarily lower than developing countries. The average METR on manufacturing in Canada for example is 35.5%, in Australia 29.4%, New Zealand 30.1% and India 23.2%. All of these are higher than the METR in manufacturing in Rwanda (17%).

Commentators typically believe that developed countries can sustain higher effective tax rates on capital than less developed countries, simply because developed economies have other characteristics that are attractive to capital investment. Less developed economies, on the other hand, need to impose low taxes on capital in order to overcome the lack of these other factors and attract capital.

However, one must be cautious in this assessment. Canada, Australia and New Zealand all have relatively high METRs on capital compared to other developed economies. Countries such as Ireland, Sweden, the Netherlands, etc., have METRs on capital substantially lower than most African countries.³⁷

³⁷ See Chen and Mintz (2005). In general it is inappropriate to compare METR calculations across different studies, as different studies follow different methodologies and make different assumptions about key parameter values and are therefore not comparable. However, importantly, we have adopted the same methodology and underlying assumptions as the C.D. Howe Institute, and therefore our calculations are directly comparable.

3. POLITICAL ECONOMY OF REVENUE COLLECTION IN RWANDA

Background

This project explores the political and institutional dimensions to tax policy and its administration with the aim of providing governments with an international, national and sector perspective. This finding may reflect both political issues and poorly devised bureaucratic procedures. For example, RAs could be specifically targeting big national or foreign companies influenced by political affiliations, bureaucratic convenience, or simply because such an approach responds to RAs' immediate incentives for maximizing revenue, but with potentially serious long-term implications for both economic growth and political stability. By analyzing the political economy of different types of business and the informal sector in relation to tax impacts, FIAS/DFID hope that governments will be able to improve tax impacts on business to improve long-term development aims. The project aims also to understand how the private sector [of all types: large/SMEs/informal/foreign & domestic etc.] and its representative bodies engage in the taxation process, with what objectives, degree of coordination and potential influence over both process and sustainable outcomes.

The project therefore seeks to produce evidence as to whether business engagement with the tax process is improving business 'voice', for example in the way that taxes are spent, so encouraging improved rates of business voluntary compliance. For example whether businesses, while doubtless seeking to minimize their taxes, accept that paying taxes gives them the right to demand effective supporting services and to achieve political representation.

Private Sector Strengthening of the 'Fiscal Contract'

Governments and the international community have begun to understand that tax is a key political basis for state/society relations. Taxation, aid and democracy are closely related in poor aid-dependent African countries. The way domestic revenue is raised significantly influences both economic growth and democratic consolidation. Bargaining over tax is central to building relations of accountability based on mutual rights and obligations, rather than on patronage.

Taxpayers' mobilization around common interests has potentially positive outcomes for governance.”³⁸

This study therefore looks at the state's 'fiscal contract' with the private sector, to consider how entrepreneurs and business organizations respond or mobilize in response to taxation. It seeks to understand how business concerns might be helping to deepen the 'fiscal contract' between government and the citizen, over how tax rules are made, revenue targets and other public priorities are set; on connecting revenue collection to productive expenditure, such as more reliably infrastructure, peace and security, and better courts; and on improving administrative processes such as transparent and fair application of laws, user-friendly rules and efficient systems to calculate and pay tax, and potentially lower rates of tax. This study examines the political economy impact of the tax mix – e.g. VAT, whilst an administratively convenient tax, raises political problems as potentially regressive and, perhaps more importantly in the long-term, from the political challenge of indirect rather than direct taxation. This may allow political elites to avoid creating consensus around direct (and progressive) taxation that binds the elites into a state-building policy: potential long-run disadvantages of the administrative short-term convenience of indirect tax may undermine the legitimacy of the state.

It is also difficult to assess the growth significance of taxation without considering government expenditure. The willingness of different groups to pay tax will depend on the political climate of revenue collection: whether the main government intention is to spend tax revenue on public goods such as infrastructure, or use revenues to benefit certain individuals or groups. The significance of such governance issues is shown by studies that indicate corruption retards development even more than taxation.³⁹ Tax impacts cannot be understood without attention to the local context of political coalitions and institutional structures– can business effectively pressure the government to devote tax to support incentives for an efficient business investment?

³⁸ As Professor Mick Moore at IDS has noted: “*If one starts from the assumption that a core governance problem lies in the dearth of bargained exchange relationships between the state and any organized societal group, then any collective action on the part of business to negotiate with the state over taxation might be considered to be potentially positive, even if it takes place entirely outside any representative or legislative institutional framework.*” M. Moore: Revenues, State Formation, and the Quality of Governance in Developing Countries: *International Political Science Review* (2004), Vol. 25, No. 3, p.312.

³⁹ Fisman, Raymond and Jakob Svensson: Are Corruption and Taxation Really Harmful to Growth? Firm-Level Evidence: World Bank, Development Research Group, November 2000, Working Paper #2485.

The Political Economy of the Rwanda Revenue Authority

Rwanda's revenue collection capability has been transformed in the last few years. The RRA was established in 1997 as a semi-autonomous executive agency and (reflecting the political origins of the government and the demography of the country) is a young organization - 90% of staff are under the age of 45. It employs around 650 staff and has eleven departments (see Annex X). With substantial financial and technical support from DFID and driven by high level political commitment to change from Rwanda's leadership, the RRA has helped raise revenue collection from 9.5% of GDP to over 13% of GDP.

RRA's Political legitimacy

Rwanda benefits from a strong sense of national purpose and legitimate authority to rebuild security, political stability and economic growth. In 2003, following adoption of a new Constitution, Rwanda successfully held national Parliamentary and Presidential elections welcomed as free and fair. Local body elections took place last year with further local elections planned for next year.

The success of the RRA has been built through establishing its strong legitimacy, underlined by its slogan of 'Taxes for Growth and Development'. Overcoming the legacy of civil war has been the key challenge, requiring the state to create security while seeking long-term stability through economic growth and effective administration, including of resource mobilization. From the outset the RRA has been able to count on the personal support of the President, who has gone on to play a major part in the campaign to change public attitudes towards paying taxes and related challenges such as corruption. The president has underlined the importance of the RRA as enabling the country to finance poverty reduction expenditure, and to reduce its dependence on outside assistance.

The President has also publicly stressed the importance of creating an enabling environment for investment, which has stimulated the RRA in making considerable effort at outreach to the private sector. In addition, the principle of the 'fiscal contract' has been well understood by Rwanda's political leadership, so the RRA has been seen to be "contributing to developing a culture of participation and citizenship as part of a wider process of establishing the norms and practices of democratic governance, and of bringing government closer to the people".⁴⁰

⁴⁰ Developing Capacity for Tax Administration: The Rwanda Revenue Authority". Tony Land, ECDPM Discussion Paper no 57D, November 2004: p.3

Politics of business taxation in Rwanda

Understanding Rwanda's tax policy and its administration requires analysis of the tax/incentive system political dynamics that link taxation, powerful vested interests, business development and economic growth.⁴¹ Particularly in a low-income country like Rwanda where the overwhelming proportion of the tax base comes from a small number of companies, large domestic and foreign companies may have strong incentives to organize and use their economic importance to secure their interests.

In Rwanda, this is difficult to assess, partly thanks to the largely even-handed nature of the way that tax reforms have been formulated by the Ministry of Finance and RRA, and the transparency of the process.

There have been noticeable differences in yields of different taxes, reflecting partly the reform process and partly political choices: International trade taxes rose from RWF 14bn to 27bn, VAT increased in the same period from RWF 24bn to RWF 47bn, and direct taxes from RWF 24bn to 39bn, of which the property tax however rose only slightly from RWF 0.6bn to 0.85bn. This, and the weakness of the devolved rental income tax now collected by sub-national government, may be the result of politically influential vested interests in avoiding effective property taxation, but more likely the need first to clarify contested land-holding arising from Rwanda's complex history, and planned land reform.

Growth and taxation in Rwanda

“Investments and private sector development are no longer issues we take for granted. We recognize them as the real engines of growth and we are pursuing their realization with determination and focus. That is why we have put in place the necessary legislative and institutional mechanisms to promote investments into our economy.”⁴²

⁴¹ e.g. S. Haber (ed): *Political Institutions and Economic Growth in Latin America*: Stanford 2000; Christian Michelson Foundation research on tax systems in Namibia, Tanzania and Uganda – e.g. Chekwoti, Caiphas 2002. “Tax compliance analyses: households and firms in Uganda.”; D. Mushi 2002. “Tax compliance in Tanzania: Why do firms evade tax?”; L.Rakner & S. Gloppen 2003. “Taxation and accountability in sub-Saharan Africa”; A. Sindzingre 2002. “Political economy of taxation and international financial institutions in sub-Saharan Africa: reforms as problems and solutions.”: Paper presented at the *Annual Conference*, Windhoek (4-5 April 2002).

⁴² The President of Rwanda at the second Rwanda Investment Conference held at Intercontinental Hotel-Kigali on 13th May, 2004

The Government has put considerable emphasis on growth. Rwanda has a small open economy, with a sizeable informal sector and is significantly non-monetized. Rwanda's economic structure is overwhelmingly agricultural. The scarcity of land requires policies that would reduce, over the coming years, the number of people depending on agricultural activities. There is no apparent sign of an 'urban bias' in Rwanda, with agriculture benefiting from general tax exemptions, reflecting the political sensitivity of the sector and the difficulty of outreach to farmers.

RRA and the private sector

The RRA approach to business has been a significant improvement on its predecessor which was noted for closing down businesses that ran in to trouble paying taxes.⁴³ The RRA was established with an understanding of the wide significance of taxation. The Board of the RRA includes not just MINECOFIN but also the Ministry of Commerce (including the RIEPA), charged with managing the relationship between the collection of revenues and creating an enabling environment for private sector investment. The Rwandan Private Sector Federation has also been actively involved in and consulted on the RRA's functions and reforms.

There are fewer than 3,000 registered companies paying national taxes in Rwanda: 280 'large taxpayers'; around 1,500 VAT registered companies; and around 1,000 companies with turnover less than 20m RWF which pay the 4% turnover tax. Customs and Excise Department and the Large Taxpayers Department [LTD] both contribute 43% to total government revenues, with 10% coming from the IRD and 4% from other sources such as the Magerwa levy. As a result, the top 13 companies are estimated to pay some 80% of all taxes collected in Rwanda, and the top 280 covered by the LTD pay around 90%. With a very large non-monetized economy and a substantial informal sector, the fiscal contract between state and citizen, and between the private sector and the state, is limited.

The FIAS/DFID mission discussions with a sample of firms on the RRA's large taxpayers register indicates a good working relationship with the RRA, with some complaints in detail about the taxation process but apparent acceptance that the net business impact is not negative.

Many changes have been or are in the process of being made, to improve tax administration, and ease the compliance burden. These include establishing in 2004 an LTD for the top 280 companies and the IRD for other taxpayers. This

⁴³Developing Capacity for Tax Administration: The Rwanda Revenue Authority". Tony Land, ECDPM Discussion Paper no 57D, November 2004: p.7.

was also linked to a greater emphasis on self assessment supported by comprehensive audit and penalties regime. At present the RRA is setting up an Operational Policy Department to formalize its processes, while introducing an integrated computer system in tax and customs [through the SIGTAS system] with a longer term aim of facilitating e-filing for large taxpayers. DFID is currently working with the RRA to improve the capacities of the HR Management and Administration Department, moving to modern performance management techniques, creating a Training Institute, and improving training and professional links with other tax administrations and international bodies.

Many of the complaints heard from the private sector represent apparent glitches in the process of implementing reform, rather than substantial systemic problems. The considerable growth in fees and fines from 131m RWF to 182m RWF from 2003 to 2004, for example, appear to represent more effective auditing. There were repeated complaints about the lateness of audits, arbitrary rulings and resultant inequity of fines imposed where rulings were unclear and audits often late. However the RRA has only recently introduced its new rolling cycle of audits in the LTD aiming to cover all taxpayers at least every 3 years, and many of the uncertainties in the interpretation of the new laws seems to be due to lack of established precedent and to the failure of the private sector to make the most of the resources available to clarify uncertainties through the legal and taxpayers services department.

RRA's administration

The government has recently approved the formalization of RRA budget to be financed by a 2.6% retention of revenue collected. This puts the RRA finances on a secure footing, enabling it to plan with confidence and to create confidence among its suppliers and employees. The new SIGTAS computer system has been rolled out now in both the LTD and the IRD, where the VAT register was updated in March 2005.

The RRA's Audit Manual spells out clear audit processes. Audit teams for example must keep detailed audit notes, recording points found during audit requiring clarification. The Heads of Audit in the LTD and IRD run case-study training sessions for staff every week to help auditors to raise potential issues and share experience. Many issues inevitably take several years to clarify. The process of introducing VAT has thrown up unforeseen problems which will need clarification or amendments to the law, ministerial orders or CG Rulings (e.g. the reverse VAT charge).

The move to the functional structure of the RRA has allowed all taxes to be audited at the same time, making for a much more efficient and effective process. The RRA recognizes that the appeals process may need strengthening – at present

the first appeal is to the same staff that made the initial decision, then the Commissioner and then to the RRA Appeals Committee, which again consists entirely of RRA staff. The private sector complain that while this lengthy process is being pursued, fines and interest costs build up. The RRA however point out that the LTD is always available to advise, that VAT-registered taxpayers have to visit the RRA monthly to file VAT returns and so can consult the LTD then, and that taxpayers are free to rectify tax returns before any audit happens simply by filing an amended tax return. RRA outreach has included for example a personal visit by the RRA's LTD staff to the 280 large taxpayers to explain the new procedures involved in the SIGTAS computerization system.

Corruption

The RRA is regarded as effective and disciplined. In 2005, Transparency International for the first time included Rwanda in its Corruption Perceptions Index. Rwanda appears at number 83 out of 158, a better rating than all other countries in the Great Lakes region and East Africa. Corruption at the RRA, while not unknown, does not appear to be the major problem.⁴⁴ The relative success of the RRA in preventing or curbing corruption appears to be due to a number of critical factors: comparatively good pay, strong internal controls, and clear political support for the RRA's management and purpose.

RRA internal incentives

It appears that RRA staff do not face distortionary internal incentives that might undermine business and growth. In the absence of incentives for overly focusing on large taxpayers to secure big wins for revenue targets, RRA staff are not apparently assessed against revenue targets, with large taxpayers already handled by a dedicated department. DFID and other donors have played a significant part in assisting the RRA with tax reforms, but there is no evidence that aid flows have created perverse incentives. The RRA has a Taxpayers' Charter of Rights that was revised in March 2005 and accessible through the RRA website, and the LTD had established customer service standards. The RRA recognizes businesses as key stakeholders, with the LTD generally regarded as effective and efficient in meeting the needs of the main contributors to the Rwandan government resources. RRA incentives therefore do not seem to clash with the interests of businesses. There is no significant evidence of business tax compliance being exchanged for greater voice and representation in economic and sector policies. The private sector was widely consulted in recent reforms aimed at creating simpler, more predictable tax legislation and supporting ministerial orders and Commissioner-General Rulings.

⁴⁴ <http://www.u4.no/themes/pfm/Revenueissue/revenue3.cfm>

The RRA is currently reviewing internal performance measures. Current performance is not evaluated by incentivizing revenue collected, and the RRA is alert to the perverse incentives that this might create. But more modern performance evaluation measures are needed, and DFID is supporting reforms in this area in the Human Resources Management and Administration Department (HRMAD).

Staff skills and turn-over

RRA staffing challenges affect the private sector. Even in the LTD there is apparently a degree of turn-over of staff that creates confusion and lack of continuity with the private sector inter-face. Managers in the LTD, while needing to ensure natural circulation of staff for career development and to prevent corruption or collusion, should attempt to keep staff in post however for perhaps at least two to three years. There are only an estimated 20 qualified accountants currently working in Rwanda. Nevertheless this represents a considerable advance on a few years ago, when Rwanda had almost “no professionals in the fields of accountancy, financial management and tax administration. Not only did this affect the government's own capacity to manage tax administration, it also meant that the private sector was inadequately served with tax and accountancy professionals. A glaring gap was the absence of professional organizations serving as intermediaries and providing accountancy, audit and tax consulting services. Also missing was a professional association able to regulate and set standards of practice.”⁴⁵

RRA outreach to private sector

The RRA has made impressive efforts at outreach and has been effective in creating a good working relationship with the private sector. Tax advisory councils established around the country feature broad civil society participation. The Rwanda Private Sector Federation, and its organization for small business, were both consulted on tax reforms, although many private sector people interviewed during the mission expressed doubt as to the effectiveness of these organizations in influencing the government or in communicating with their members.

The RRA efforts are reflected in the RRA’s 2005 Corporate Plan that notes: “Revision of the tax laws to make it more current, certain, fair and simple will increase taxpayer compliance and reduce costs of tax administration. Pertinent

⁴⁵Developing Capacity for Tax Administration: The Rwanda Revenue Authority”. Tony Land, ECDPM Discussion Paper no 57D, November 2004: p.44

provisions include the increase in presumptive taxation threshold to 20 million RWF, which will minimize the burden of compliance for small and medium taxpayers. Similarly, the provision for tax practitioners that hold them liable for their negligence will yield positive results in the medium term for large taxpayers. Furthermore, revision of the penalty regime to align penalties with the level of culpability as well as the introduction of the formal ruling system will greatly improve taxpayer compliance in the medium term. ... It is also important to note that despite intensive tax sensitization campaigns, the taxpaying culture is still low and this is evidenced by a big amount of revenue that is collected through audits and arrears. In 2002, 46% of corporate tax collections were from audits and arrears. In 2003, this collection amounted to 30%. While there has been a significant improvement in this area, there is still a need for concerted effort to improve compliance. Additionally, the level of financial accounting is still low and the laws obligating disclosure of financial accounts are still weak, which adversely affects compliance with their tax obligations.”

The private sector, however expressed concerns that despite the enormous progress in recent years, current tax laws still lack clarity and regulations were interpreted in too arbitrary and unpredictable a fashion. The RRA does give staff regular training, audit manuals do clarify procedures, the new Operational Policy Department should help consolidate the formalization of many standard procedures, and a degree of uncertainty is inevitable when most clauses in new laws have not been formally challenged by either the appeals proceedings or court rulings. Nevertheless, the RRA needs to do more to advertise the facilities available to clear up confusion through the Legal and Taxpayer Services Department (LTSD). Several private sector firms complained that RRA officers would simply tell them that “it was the law” without explaining either the detailed explanations available through taxpayer education initiatives, the LTSD, Tax Advisory Councils’ forums around the country, and how to access Ministerial Orders and the RRA Commissioner-General Rulings.

Private Sector capacity to mobilize around tax

In Rwanda available evidence on the role of business in influencing the political debate around both tax policy and tax administration appears limited.⁴⁶ This was true for both the 13 large taxpayers that account for around 80% of Rwanda’s tax take, but also for the tax impact on small businesses in the broader political

⁴⁶ For regional comparison, see: D. Mushi 2002. “Business environment and attitudes toward tax: implication on firm compliance behaviour in Tanzania.” Submitted to *Economic Development and Cultural Change* for review by Christian Michelson Foundation; Kasimbazi, Emmanuel 2003. “Taxpayers’ rights and obligations: Analysis of implementation and enforcement mechanisms in Uganda.” *Development Research Working Paper* (submitted for review). Institute for International Studies (IIS), Copenhagen.

economy context.⁴⁷ As a result, it was not possible in the time available to see if sector differences in taxation are the result of political economy factors. Some foreign companies may have secured investment concessions due to government concern to attract FDI, but this does not seem to represent wider evidence of small politically well-connected vested interests undermining overall growth agenda for sustainable poverty reduction.

The private sector and indeed all stakeholders were consulted extensively during preparation of the legislation, but the impact of this seems to have been limited. It is not clear whether this is because large businesses already have the political influence they need through other channels, and that SMEs are politically less relevant. The evidence from the RRA is rather that the public sector carries much more weight in Kigali than private sector concerns and interests.

There remains however, doubt about the effectiveness of the Private Sector Federation to represent the interests of its all members to government or to facilitate training of members on tax issues. Few members for example seemed aware of the VAT option and its merits. It seems that the Rwandan Private Sector Federation is inadequately staffed and funded to effectively engage with the MINECOFIN and RRA on tax policy and its administration that effects business development and pro-poor growth concerns. Inevitably small and informal sectors are less influential.

Conclusions and Recommendations

More effort is needed to help the government tackle the important challenge of creating a strategy to develop simple and undemanding procedures that would allow the informal sector to gradually enter the formal economy. At the same time the government needs to maintain and further develop the culture of political accountability through the ‘fiscal contract’ between taxpayer and the state especially through direct taxation, property taxes and the widening of the business tax base, along with a strengthened Private Sector Federation to help the private sector play an effective role in shaping national growth development strategies.

Tax impact on business

Despite the impressive efforts of the RRA in outreach and education, more engagement with taxpayers is needed, in part to overcome the strong cultural reserve in Rwanda over questioning decisions by the authorities.

⁴⁷ e.g. Therkildsen, Ole 2000. “Understanding taxation in poor African countries: A critical review of selected perspectives.” *Forum for Development Studies*, Vol. 28, No. 1, pp. 99-123.

To achieve this in Rwanda, the Private Sector Federation still needs to be strengthened if it is to be more effective in voicing operational concerns to help the government, MINECOFIN and RRA structure pro-growth tax laws, rulings and orders.

More workshops should be run by the LTD and IRD to explain to different sectors the various specifics of their tax impact and procedures in their sectors. Several firms suggested that staff at the RRA needed more sector expertise. The RRA does send some staff abroad for training, and the RRA is looking to establish its own training institute and to create an agreement with a developed country tax authority's training centre to facilitate best practice experience.

The RRA seems not to be consulted by either Government, donors or IFIs when it comes to drawing up major policy plans that involve the private sector and practical ways to draw in the informal sector and broaden the 'fiscal contract' between citizen and state. We recommend that donors and IFIs seek greater understanding of these issues.

Compliance costs

Despite impressive reforms in the RRA, some among the private sector interviewed felt that real compliance costs were higher in Rwanda than the official figures would suggest, and so were driving away both domestic investment and FDI. This mission to Kigali was not able to make a full assessment of the impact of real compliance costs on business productivity and competitiveness.

Future work should aim at adapting existing methodologies for calculating compliance costs (in terms of hours away from a business, or as a % of sales or GDP per capita) and comparing these across different businesses, sectors, or geographical regions.

Improving outreach to the informal sector

To reduce the cost of being formal to encourage companies to register, the RRA needs support on prioritizing the growth aspects of taxation that may require simplified processes to allow the informal/SMEs to enter the formal sector, benefiting from the possibilities of doing so – e.g. reclaiming VAT or bidding for government contracts. This indicates further RRA attention to outreach and education to the informal and SME sectors. A workshop is planned at the end of this series of country studies, to be held in the region in 2007, which may produce comparative experience of use in this area.

Strengthening tax policy capacity of MINECOFIN

The DFID Evaluation of Revenue Projects (2001) urged increased donor support for developing country governments to improve their capacity to analyze tax policy. RAs have been effective at revenue maximization, but perhaps not enough attention was given when setting up RAs to the need to strengthen at the same time the policy making capacity of MOFs, to ensure that broader social needs including supporting growth strategies were also given adequate attention. MOFs may be weak at tax policy where the RA is effective and comparatively well-paid and well resourced. This seems to be developing as a significant issue in Rwanda, where graduate entry salaries in RRA may be up to 12 times that in MINECOFIN.

Capacity in MINECOFIN has been retained through donor projects, but there has been an inevitable steady attrition of capable MINECOFIN staff either to the RRA or to the private sector. Many informed interviewees noted the comparative weakness of MINECOFIN to set tax policy and manage reforms to ensure that overall macroeconomic guidance was reflected in nationally agreed political priorities, linking revenue collection to expenditure. By comparison the RRA's Planning and Research Department is comparatively well staffed and supported. There is thus a danger of administrative convenience driving tax policy.

Fiscal decentralization: The government's plans for decentralization, including of tax collection may help in incentivizing local officials, but will present political and institutional challenges. Serious consideration should be given to its part in the overall national growth strategy and the 'fiscal contract', as well as creating effective local administrations linked to the Provincial Coordination Office of the RRA.

Further strengthening the 'Fiscal Contract' in Rwanda

Rwanda has paid impressive attention to the long-term political importance in the citizen's link to state. Given the strong political commitment and direction from the presidency, there is probably less concern over 'political will' affecting the RRA than might apply in neighboring countries.

There may be an efficiency case for greater staff resources in LTD, but this may be at the political cost of failing to put adequate effort into expanding the tax base, to draw more of the informal sector in to the formal economy and so expand the 'fiscal contract'. It seems significant that the large taxpayers interviewed did not have major complaints about the LTD's effectiveness, only issues of equity over processes.

Nevertheless, this project's final workshop should encourage partner countries to devise practical small steps to address the private sector dimension to the linkage between taxation, legitimacy and long-term political stability.

Annex A: An Overview of the METR Methodology

A General Discussion

The concept of a marginal effective tax rate was created to analyze in a single measure how investment decisions are affected by the large number of provisions of the business and individual income tax systems, as well as by features of any property and wealth taxes, sales taxes including VATs, customs duties, and special incentive regimes such as tax holidays, that affect the incentives to invest. METR analysis is based on the standard neoclassical model of investment in which the level of investment is a function of the “cost of capital” faced by a firm – the minimum or “hurdle” rate of return that an investment must earn to be profitable. Although earlier research was mixed on the issue, the most recent empirical evidence confirms the basic assumption of this model – which investment does in fact react inversely to changes in the cost of capital (Gordon and Hines, 2002). METR analysts, such as King and Fullerton (1984), Broadway, Bruce and Mintz (1984) and many others, have taken the basic neoclassical model and modified it to take into account the net effect of all the provisions of a tax system on the cost of capital to the firm.⁴⁸ The primary goal of an METR analysis is thus to describe this net effect of a tax system on investment incentives in a straightforward and intuitively appealing form.

The METR terminology naturally provides some insight into the nature of this tool. A METR is *marginal* because it is based on analysis of a prospective incremental investment – one that just breaks even, with its after-tax cost equal to its after-tax returns.⁴⁹ It calculates the *effective* tax burden in that it captures the net effects of all the provisions of the tax system, rather than focusing on a single characteristic such as the maximum statutory corporate tax rate. And it is a *tax rate* in that it is defined as the difference between the gross of tax and net of tax returns to an investment – the “tax wedge” between gross and net returns created by the tax system – expressed as a percentage of the gross return.

The calculation of a METR requires careful specification of the characteristics of an investment in a specific asset in a specific sector, including the time path of its returns, the rate of economic depreciation of the asset, how the asset is financed, the economic environment in which it occurs, including the inflation rate, interest

⁴⁸The analysis in this paper most closely follows the approach in Broadway, Bruce and Mintz (1984). For an application of the King and Fullerton (1984) approach to Burundi, see Zodrow (1993).

⁴⁹METR analysis is thus not well suited to analyzing tax effects on investments that generate above-normal returns.

rates, and returns to equity, and all of the features of the current or proposed tax system that affect both the after-tax returns and the after-tax costs attributable to the investment, including all tax depreciation allowances, investment credits, interest deductions, special exemptions, etc., allowed under the income tax as well as any other taxes that impinge on investment decisions. Given this information, the analysis calculates the effective tax rate on a marginal or breakeven investment under the assumptions of profit maximization by the firm, competitive markets, and perfect certainty (e.g., with respect to future returns and inflation rates).

Several additional assumptions underlying the METR approach should be noted. For example, METRs assume that firms are profitable, so that if the effective tax rate on an investment is negative (it is subsidized at the margin), the resulting losses can be used currently to offset other income. METR calculations are typically static; that is, they usually assume that the tax system in place at the time of investment remains unchanged for the life of the investment, and that inflation, when included in the analysis, also remain constant. Since the analysis typically assumes that assets depreciate at a constant rate but last forever, strictly speaking this implies that the analysis assumes the tax system and inflation rate remain fixed forever. In addition, the calculation of METRs is partial equilibrium in nature. Thus, some rate of return in the economy must be taken as fixed; in the context of a small open economy such as that of Rwanda, it is natural to take as fixed an interest rate that is determined in international capital markets. The return to equity, inclusive of an equity premium, can also be treated as determined in international markets.

Another implication of the partial equilibrium nature of METR analysis is that it cannot be used to analyze the shifting of business taxes to consumers or workers (that might occur with market adjustments in the context of a general equilibrium model of the economy). Instead, METRs typically implicitly reflect rather simplistic assumptions regarding tax incidence – which capital taxes on specific assets are borne by the owners of those assets, that taxes on labor are borne by labor, and that general consumption taxes are borne by consumers. Accordingly, to the extent that these incidence assumptions are incorrect, reported METRs levels and differentials may be somewhat misleading. METRs also typically do not take into account issues of tax administration, compliance and evasion, as they describe the tax system as it would operate if it were effectively administered and enforced. Again, to the extent that certain types of taxes (e.g., taxes on capital assets rather than capital income) are more easily enforced than others or are plagued with less tax evasion, the reported METRs may be misleading with

respect to the effects of the tax system as it actually affects investment decisions and tax revenues.⁵⁰

Finally, as noted above, a METR is defined as the tax wedge between the gross of tax and net of tax returns earned by a marginal investment, expressed as a percentage of the gross return. (The "gross" and "net" terminology refers to returns before and after taxes; both types of returns are defined net of actual economic depreciation.) The net return can be measured at the company or "entity" level, in which case only entity level taxes (including withholding taxes) are considered. Such calculations are sometimes referred to as "open economy" METRs, since the taxation of saving at the level of the saver is ignored. Alternatively, the net return can be measured at the level of the "saver" or provider of funds; in this case, the calculation includes taxation at the individual level. Such calculations are sometimes referred to as "closed economy" METRs since the source of investment funds is assumed to be domestic savers. Since the focus of this report is on tax effects on investment, including foreign direct investment, and Rwanda closely approximates a small open economy, the METRs presented are calculated solely at the business level (including, in some cases, withholding taxes on repatriations of funds from Rwandan subsidiaries to their foreign parents).

The basic concept of a METR can be illustrated with the following simple example. Suppose a business makes a marginal investment in a capital asset that just breaks even taking into account all taxes in the system, and earns a return of ten percent net of depreciation but before any taxes. Suppose further that, after accounting for all taxes, the net real return received by the firm and paid to its investors is seven percent. In this case, the METR on the investment is thirty percent – $0.3 = (0.10 - 0.07)/0.10$.

B Issues Illuminated by METR Analysis

The primary applications of METR analysis are twofold. First, the results of an METR analysis show the net effect of all components of the tax system on the *level* of the taxation of capital income generated by the marginal investment analyzed. Thus, a METR provides a measure of the actual tax burden on a prospective investment attributable to the existing (or proposed) tax system. Moreover, an appropriately weighted average of the METRs on specific types of investments can be constructed to provide a measure of the overall level of

⁵⁰Note also that since METRs are calculated for marginal investments they are not a particularly good indicator of the tax revenues that are raised from taxing capital income, which depend heavily on the taxation of inframarginal and other investments that earn above-normal returns.

taxation of capital income in the economy, showing how the tax system distorts investment decisions (and, if individual level taxes are considered, saving decisions as well) and thus introduces inefficiencies or “excess burdens” into the economy.⁵¹

Second, by considering a wide variety of investments that differ by asset, method of finance, investor or economic circumstances, METR analysis provides an indicator of the tax differentials that arise across different types of investments, that is, it shows how taxes affect the *composition* of investment. In particular, a METR analysis shows how the tax system results in a variety of distortions of investment decisions, thus creating additional efficiency losses, beyond those associated with simply taxing capital income at a uniform effective tax rate. The most commonly cited distortion is across types of assets, as differential taxation of different types of assets induces businesses to invest too heavily in tax-advantaged assets and too little in tax-disadvantaged assets. This of course translates into distortions across business sectors, as the tax system favors sectors with production processes that use tax-favored assets intensively and penalizes businesses that use relatively heavily taxed assets intensively. The following subsections discuss these distortions and a wide variety of others, all of which can be analyzed with an appropriately designed METR analysis.

Distortions of the Level of Investment and Saving

METRs provide an indication of the overall level of taxation of various forms of capital income and thus indicate how the tax system affects investment and saving decisions. Because they consider many aspects of the tax system, METR analyses often give very different results regarding the effects of the tax system on

⁵¹Note that “distortions” of investment decisions must be measured relative to some benchmark. In general, a tax system would not distort investment decisions only if the METR were zero on all types of investment; this would occur, for example, under an ideal consumption-based tax (Zodrow and McLure, 1991). In this case, METR differentials – and the associated distortions of investment decisions – would be measured relative to a benchmark tax rate of zero. However, under an income-based tax, the benchmark level of taxation of capital income is typically the statutory income tax rate. In this case, the distortion of saving/investment decisions implied by the taxation of capital income at the statutory rate is in a sense taken as given, and the distortions attributable to tax differentials are measured relative to the statutory income tax rate. In addition, note that this discussion assumes that efficiency requires a tax system that is neutral across assets. This need not be true. For example, tax differentials may be desirable to correct for negative production externalities (e.g., pollution) or to offset other inefficiencies in the economy (e.g., inefficiencies in the taxation of labor income). These complications are ignored in the analysis, as they are best addressed with specific tax policies as needed (e.g., taxes on effluents or reform of the system of labor income taxation) rather than through the ordinary income tax system applied to capital income; for further discussion, see Gugl and Zodrow (2004).

investment decisions than would a simple examination of statutory tax rates (or special preferences) in isolation. Effective tax rates that are far above or below the statutory rate indicate potential areas for reform, as relatively high positive rates act as a deterrent to investment, while negative METRs suggest that the tax system stimulates investments that are socially undesirable because they earn a return lower than the opportunity cost of funds.

Distortions of the Allocation of Investment

METRs are also very useful in identifying the extent to which the tax system distorts investment allocation decisions by asset and by business sector (given the benchmark level of taxation of capital income in the tax system). Apart from the arguments for differential taxation noted above, most public finance economists would argue that competitive markets are generally efficient in allocating resources. The implication of this view is that tax differentials are generally undesirable because the associated distortions of investment allocation decisions result in reduced productivity of investment; that is, a disproportionate amount of capital is allocated to those sectors and assets in which tax treatment is relatively favorable rather than to those sectors and assets where investment would be most productive in the sense of generating output valued by consumers. In other words, the tax system should generally be characterized by "economic neutrality" with respect to investment allocation decisions, or METRs that do not vary according to the type of asset or business sector.

In addition, METR analysis demonstrates the extent to which certain types of preferential treatment confer an advantage to the tax-favored activity. Indeed, METR analysis can be used to determine whether the effects of "preferential" treatment of certain forms of investment are in fact consistent with the intent underlying such treatment. For example, in some cases such as certain types of tax holidays, supposedly preferential treatment results in METRs that are actually higher than those under the ordinary income tax system. Similarly, a preferentially low tax rate in a sector can have the effect of increasing METRs if depreciation deductions and other investment allowances under the regular tax system are sufficiently generous.

Method of Finance

MTR analysis is useful in determining whether the tax system favors one form of finance over another. Under a market-based approach to tax reform, such distortions are also undesirable as they imply a tax-induced alteration of the allocation of risk-bearing in the economy. For example, a tax bias toward debt finance may increase the overall indebtedness of firms and thus increase the likelihood that costly bankruptcies – or perhaps even more costly government bailouts – will be incurred during an economic downturn.

In addition, tax differentials across methods of finance may discriminate against certain types of firms. For example, a tax system that results in an unusually high METR on new share issues will discourage investments by firms that tend to use new issue finance to a disproportionate extent, including new enterprises that have little retained earnings and limited access to debt finance. Again, most public finance economists would argue that neutrality with respect to firm financing decisions is a desirable property of tax system.

Choice of Organizational Form

METR analysis identifies the extent to which the tax system distorts decisions regarding the choice of organizational form. Typically, firms may be organized as corporations subject to the corporate income tax or non-corporate entities that are taxed on a “pass through” basis, with business income attributed to the individual owners and taxed under the personal income tax. Economic neutrality with respect to decisions regarding organizational form is also generally desirable, so that firms may select the form of business organization that best meets their needs without worrying about differential tax consequences.⁵²

C Effects of Inflation

An important benefit of METR calculations is that they can be used to demonstrate how tax rate differentials, as well as the level of capital income taxation, vary with the rate of inflation. Unless a tax system is completely indexed for inflation, the pattern of METRs will be different for each expected steady state rate of inflation. The fluctuations of METRs with inflation can be considerable, especially for large differences in the expected inflation rate. Note that such variation in METR levels and differentials with inflation adds an element of complexity to investment decisions, as it makes it more difficult to interpret the effects of the tax system on alternative investments. Such uncertainty is likely to reduce the overall level of investment at any given inflation rate.

⁵²As in the case of resource allocation, there may be externalities associated with the choice of organizational form; for example, tax enforcement may be less costly for firms that are publicly held corporations.

Annex B: Calculation of marginal effective tax rates

The calculation of METRs is outlined in this appendix. For further details, consult Boadway, Bruce and Mintz (1984) or King and Fullerton (1984). Consider an investment in an asset that costs q , has a marginal revenue product of c , and lasts forever but depreciates exponentially at a constant rate of economic depreciation δ . Suppose further that the corporate income tax rate is u , the net indirect tax rate on the purchase of the asset (due to non-creditable VATs, customs duties, sales taxes, excise taxes, transaction taxes, etc.) is t (which is included in the tax basis of the asset), and an initial investment allowance of n is granted (with no adjustment of basis). Let z be the present value of the depreciation deductions allowed under the income tax, per dollar of investment, over the life of the asset. For example, if the tax code allows exponential (declining balance) deductions at rate α , with no adjustment for inflation,

$$z = \int_0^{\infty} \alpha q e^{-\alpha t} e^{-(r^f + \pi)t} dt = \frac{\alpha q}{\alpha + r^f + \pi},$$

where r^f is the firm's real discount rate and $r^f + \pi$ is the firm's nominal discount rate where π is the expected steady state rate of inflation. To calculate r^f , assume that the debt-asset ratio is fixed at β , the nominal interest rate is i and the return required by equity holders (which reflects dividends and capital gains) is ρ in which case

$$r^f = \beta(1-u)i + (1-\beta)\rho,$$

reflecting the deductibility of interest payments coupled with the lack of deductibility of payments to shareholders. The calculation of a marginal effective tax rate (METR) assumes that a marginal investment in an asset just breaks even, that is, that the net benefits generated by the investment, taking into account all tax factors, just equals the after-tax net cost of the investment. For a depreciable asset this requires

$$(1-un)(1+t)q = (1-u) \int_0^{\infty} c e^{-\delta t} e^{\pi t} e^{-(r^f + \pi)t} dt + u(1+t)qz$$

$$(1-un)(1+t) = \frac{(1-u)(c/q)}{\delta + r^f} + u(1+t)z$$

$$c/q = \frac{(1-un)(1+t)(\delta + r^f)}{1-u} - \frac{u(1+t)z(\delta + r^f)}{1-u}$$

The gross return to the asset, net of depreciation, is thus

$$r_g = c/q - \delta = \frac{(1+t)(\delta + r^f)}{1-u} [1 - u(n+z)] - \delta.$$

For land, the gross return is obtained by setting the depreciation rate in this expression equal to zero. For inventories, the gross return is obtained by setting the depreciation rate in this expression equal to zero and, in the case of FIFO inventory accounting, adding a term to r^f equal to the product of the corporate tax

rate and the inflation rate to the numerator.⁵³ Finally, letting r_n denote the net return to investment, the marginal effective tax rate on the investment is

$$METR = \frac{r_g - r_n}{r_g} .$$

⁵³ See Broadway, Bruce and Mintz (1982).

Annex C: Description of the tax structure in Rwanda used in the METR calculations

By “tax structure,” we mean tax provisions stipulated in the tax laws rather than the tax administration that affects how the tax structure is implemented. For example, when a business sector is taxable under the value-added tax (VAT), the law implies that firms in this sector are entitled to a full refund for the VAT paid on their capital inputs, or input tax credit. In terms of tax structure, therefore, this sector as a whole bears no VAT cost on its capital inputs. However, it is quite possible that, owing to administrative delays or even intentional denial, many firms in this sector might not be able to receive the input tax credit on time, if at all. When they do not receive the input tax credit on time, they have to bear the cost of cash flow that is held up by the revenue authority; and when they do not receive the input tax credit at all, they have to bear an indirect tax cost on their capital investment. Both problems in this case are the result of poor VAT administration rather than the tax structure itself. As such, METR analysis should not be expected to quantify the investment impact of tax administrative efficiency since it only deals with the investment impact of the tax structure.

Generally speaking, the principal taxes affecting capital investment and business activities may be divided into two types: direct taxes on income generated from capital investment and transaction taxes on capital inputs. The direct taxes normally include company income tax, taxes on financial investment income⁵⁴, and some other taxes either based on capital or based on gross receipts; and the indirect taxes on capital inputs include sales tax (including VAT) and import duty on capital inputs that are not refundable to investors.

In Rwanda, the principal direct taxes affecting capital investment are stipulated in the newly approved Law of 2005 on *Tax on Direct Income* (henceforth the New Law), but also include certain taxes levied locally (e.g., property tax). Indirect taxes on capital inputs are virtually non-existent except for the non-refundable value-added tax (VAT) on capital goods in certain segments of the financial services sector (see below). Our review of these taxes starts with a description of the general tax provisions, followed by a review of special tax incentives and taxation of small business.

⁵⁴As illustrated by the effective tax rate analysis, taxes on any financial investment income could affect the cost of capital investment through the financing cost of capital.

Direct taxes

The company income tax (CIT)⁵⁵ is 30 percent in the New Law, reduced from 35 percent in the Old Law. The company tax applies to all profit-seeking enterprises, including both incorporated business entities and unincorporated ones such as co-ops and partnerships.

The capital depreciation allowance: Compared with the Old Law, which provided a complicated scheme of depreciation allowances⁵⁶, the New Law provides a much more straightforward scheme (Art 24), which categorizes depreciable assets into four categories with each category having a clear-cut depreciation rate. The four classes and their depreciation rates are: buildings and structures (5%), intangibles (10%), computers and other computerized systems or equipment (50%), and machinery and equipment (M&E) and other business assets (25%). While the first two rates are applied to original cost (i.e. using straight-line depreciation methods), the last two are based on cost balance (i.e. using declining-balance depreciation methods). It is also noteworthy that a depreciation base of under RWF 500,000 may be deducted entirely as business expense.

The interest deduction: As a general rule, interest expense is deductible for CIT purposes. To prevent excessive borrowing, the New Law adopts a “thin capitalization rule” that allows only interest expenses within a debt to assets ratio of 80 percent.

Inventory accounting method: All stock other than work-in-progress is valued at cost or market price, whichever is lower. As indicated by officials at the Rwanda Revenue Authority (RRA), the last-in-first-out (LIFO) is generally used for inventory accounting.

Loss carry-over: Business losses may be carried forward for five years, with earlier losses having to be deducted from taxable income before later ones.

Taxation of financial investment income: both dividends and interest income are taxed at a flat rate of 15 percent if received by individuals. Capital gains are taxed as ordinary income. When the recipients of these incomes are companies, interest and capital gains are taxed at the company income tax rate of 30 percent and dividends received from a resident company are exempt from taxation.

⁵⁵In the English version of the New Law, the wording is “corporate” income tax rather than company income tax. The term “company income tax” would be more appropriate considering this tax applies not only to incorporated business entities but also unincorporated ones as listed in the text.

⁵⁶Refer to Law No. 8/97 of 26th June 1997, Article 13.

Property taxes: Taxable properties are categorized as buildings and structures, undeveloped land, and vehicles. While tax on vehicles is collected by the Revenue Authority, *all taxes levied on immovable properties (including tax on rental income) are local taxes that were decentralized to the local authorities in 2002.*

Property tax on buildings and structures is based on the “determined value” with a tax rate of between 0.1 - 0.2 percent, as fixed by the district and town councils. Tax on undeveloped land is also set by the district and town council at a fixed amount per square meter. On mining concessions, the tax is levied as a fixed amount per square meter of the surface area of mining concessions or quarries. The rate varies according to the stage of mining (i.e. exploration, prospecting, and quarry mining). There is also an annual tax (calculated based on a specially designed formula) on farm land.

Tax on vehicles is calculated according to type of vehicle, engine power, or weight.

Indirect taxes

The principal indirect taxes that may affect capital investment are VAT and import duty on capital goods that are not refundable to investors.

Among the five sectors subjected to METR analysis, only about 25 percent of financial services may not be able to claim VAT refunds owing to their VAT exempt status⁵⁷. All other sectors are either taxable under VAT (and hence can claim input tax credits) or are exempt from VAT on both input and output (e.g., the agricultural sector).

Under the import tariff, imported capital goods are zero-rated⁵⁸ and hence bear no duties.

There is no property transfer tax in Rwanda although capital gains from property transactions are taxed as ordinary income.

1. Special Tax Incentives Conditional on the Investment Code

Although the New Law aims to provide a more efficient, simple and fair tax structure and the Investment Code in Draft⁵⁹ contains no direct provision for tax incentives, the New Law still provides several special tax incentives in conditions

⁵⁷ This is our sector expert’s estimate.

⁵⁸ Refer to Stotsky, et al (May 2003).

⁵⁹ See “Law No...of.....2004 *Relating to Investment and Export Promotion and Facilitation*”.

defined in the Investment Code. To that extent, the Investment Code still plays a significant role in providing tax incentives, and the majority of business investors who do not possess sufficient financial capital to be able to register under the Investment Code⁶⁰ are unable to enjoy the tax incentives provided in the New Law.

First, an investment allowance is introduced in the New Law (Art.26). This investment allowance, however, is available only for those “registered investors” whose annual capital investment exceeds RWF 30 million. The allowance is 40 percent in general but 50 percent in particular for registered investors located outside Kigali or that fall within the priority sectors listed in the Investment Code. Four out of the five sectors included in our analysis are on the list of priority sectors: agriculture, manufacturing, mining and tourism.

Second, a *progressive tax discount scheme* (Articles 41 and 42) is introduced in the New Law whereby the CIT rate is reduced by prescribed percentage points according to the number of employees or the revenue from exporting a firm generates. This conditional tax discount benefits large employers hiring at least 100 workers for at least six months during a tax year or large exporters generating at least \$3 million annually. The tax discount ranges from 2 to 7 percentage points for large employers and 3 to 5 percentage points for large exporters.

Third, the New Law also provides two narrowly targeted *tax holidays*. One is a renewable 5-year income tax exemption for firms carrying on “micro finance” activities approved by competent authorities (Art. 42); and the other a permanent income tax exemption for foreign companies that have their headquarters in Rwanda or a registered investment entity that operates in a Free Economic Zone (Art. 41).

In summary, all the tax incentives introduced in the New Law are aimed at attracting large capital investment to Rwanda. Statistics shows that these tax incentives will benefit only a handful of firms. For example, among 185 “registered investors” currently operating in Rwanda, only 30 hire more than 100 employees and hence can benefit from the tax discounts. Considering that there are nearly 60,000 business enterprises in Rwanda⁶¹, the 185 registered investors that can enjoy special tax incentives account for only 0.3 percent of the total.

⁶⁰ According to the Investment Code, only those foreign investors that invest a minimum financial capital equivalent to US\$250,000 and those local investors (including those from COMESA countries) who invest a minimum financial capital equivalent to US\$100,000 can register under the Investment Code as a “registered investor.”

⁶¹ See Rwanda Private Sector Federation (2005).

2. Taxation of small business

Small business in Rwanda is defined by turnover or gross receipts. That is, any business with an annual turnover up to RWF 20 million is defined as a small business. This is a result of recent unification of two different thresholds for defining small business under the VAT and the income tax law. These two different thresholds were RWF 15 million and RWF 36 million respectively. The uniform threshold certainly helps streamline the tax administration of small businesses.

A small business as defined above does not have to register for VAT but has the option to register so as to claim the input tax credit under VAT. Furthermore, a small business has to pay a 4-percent turnover tax in lieu of the 30-percent company income tax. Again, it can opt to pay the 30-percent company income tax instead of the 4-percent turnover tax. Income derived from farming and agricultural activities is exempt if the turnover from these activities is below RWF 12 million in a tax period. (Art. 18)

With these options, the provisional tax status for small business in Rwanda, excluding small agricultural entities with turnover under RWF 12 million, falls into three groups: 1) those paying the turnover tax but not VAT; 2) those paying the turnover tax as well as VAT; and 3) those paying VAT and the company income tax rather than the turnover tax. By “provisional”, we mean this categorization is made according to law. In reality, it is not uncommon for small businesses to pay no tax or under-report gross proceeds to reduce their turnover tax payable by law. Also note that paying the turnover tax means firms are unable to claim any income tax allowance such as the interest expense and capital depreciation allowances; and paying no VAT means firms are unable to claim refund for the VAT paid on their capital input. Therefore, the third group of small business may claim more tax benefit than other two groups.

In summary, the New Law, together with the Draft Investment Code, has a clear goal of encouraging capital investment and facilitating business activities. It is noteworthy that the New Law is a result of tax reform undertaken by the government following advice given by the IMF, DFID, and other international donors⁶². Compared with the income tax law that is currently effective (henceforth the Old Law)⁶³, the New Law is clearly intended to lower tax burdens and ease tax compliance for taxpayers by reducing income tax rates, unifying the thresholds for defining small business under CIT and VAT, providing a

⁶² Refer to Stotsky et al (2003), Kloeden et al (2003, 2004), and DIFD/FIAS (2005)

⁶³ Refer to Law No 8/97 of 26 June 1997 on the Cod of Direct Taxes on Different Profits and Professional Income, as amended up to 31 December 2002.

straightforward depreciation allowance scheme, and limiting income tax exemptions to a minimum number of cases.

Our discussions with tax experts at the Ministry of Finance and the Revenue Authority, however, indicate that there is room for improving the New Law to further alleviate tax distortions. As described above, these tax distortions mainly relate to tax incentives granted based on performance levels (e.g. tax discounts based on number of employees or revenue from exports, and investment allowances based on the amount of capital invested) or business nature (e.g. micro-finance or companies having foreign headquarters), which do not benefit the majority of business enterprises in Rwanda but complicate the tax structure. We also learnt that most of these special incentives were introduced in the New Law after representations from special interest groups in Rwanda.

Annex D: Cross-country analysis

Assumptions

The data for this analysis is taken entirely from country studies prepared by the International Bureau of Fiscal Documentation for Malawi (2003), South Africa (2003), Tanzania (2002) and Zimbabwe (2004). Since these data are incomplete and may be dated, and because not all features of the tax system in each country are considered, the METRs calculated below should be regarded as tentative and used for rough comparison purposes only.⁶⁴ As in the base case for Rwanda, the calculated METRs reflect business level taxes only and do not consider any withholding taxes on interest or dividends. In addition, all of the countries considered have broadly similar indirect taxes, with creditable VATs with rates that range from 14-20 percent (recall that the standard rate for the VAT in Rwanda is 17.5 percent) and have customs duties that typically range from zero to 25 percent (although specific data on how the customs duties apply to capital goods are not available).

Accordingly, the METR calculations simply assume that the same effective indirect tax structure applies in all of the comparison countries as that assumed in Rwanda, with machinery subject to an effective indirect tax rate of 20 percent in the financial sector, 10 percent in the agricultural sector, and 5 percent in the tourism and manufacturing sectors, coupled with a 5 percent indirect tax rate on inventories in the tourism sector. These assumptions also help focus the analysis on a comparison of the differences in income taxes across the various countries. The analysis also assumes that FIFO accounting is used in all of the comparison countries – this is explicit in the description of the tax code for South Africa (which bans the use of LIFO), and assumed for the other comparison countries. Finally, all other parameters, such as real after-tax rates of return and debt-equity ratios are assumed to be the same in all countries, with the exception of inflation rates, which reflect 2003 values of 6.0 percent in South Africa, 9.6 percent in Malawi, 4.4 percent in Tanzania and 51.4 percent in Zimbabwe.

⁶⁴As above, various provisions noted in footnotes are listed for completeness only and are not reflected in the comparison country METR calculations.

Annex D. Comparator Country Tax Incentive Regimes 1/

	Rwanda	South Africa	Uganda	Kenya	Tanzania	Zambia
1. Country-wide						
Tax incentives	Tax holidays available (3 years urban 5 years rural) for micro/small businesses. CIT, VAT, and tariff reductions available in some sectors or in mining, for some individual firms.	Tax holiday for firms incorporated between 1996-1999. Other incentives such as SME development program for manufacturing sector firms (up to ZAR 3 million), other SME support, and a skills support program. DTI lists 90 different types of fiscal and non-fiscal incentives	Investors can qualify for duty and sales tax drawbacks by satisfying three of the following criteria: the generation of new earnings or savings of foreign exchange through exports, resource-based import substitution or service activities; using local materials, supplies and services; creating employment opportunities in Uganda; introducing advanced technology; contributing to locally or regionally balanced socio-economic development. These drawbacks are also extended with foreign capital investments over USD 500,000 and domestic investments	There is no codified investment scheme in Kenya to attract investors, but incentives do exist in the form of various allowances and waivers of import duty, which can be negotiated individually with the Ministry of Finance.	No CIT tax holidays, other tax incentives given to priority and lead sectors (see below)	Tax holidays available (3 years urban 5 years rural) for micro/small businesses. CIT, VAT, and tariff reductions available in some sectors or in mining, for some individual firms.

Corporate income tax	Basic rate: 35 %--45% for financial sector in excess of K 250 million, ad hoc reductions for some sectors	Basic rate: 29 %, concessional rates for mining and SMEs	over USD 50,000. Basic rate: 30%	Basic rate: 30%	Basic rate: 30%	Basic rate: 35 %--45% for financial sector in excess of K 250 million, ad hoc reductions for some sectors
VAT rate (general)	17.5%, deferments for specific items, VAT only applicable for firms turnover over minimum threshold	14%	17%	16%	20%	17.5%, deferments for specific items, VAT only applicable for firms turnover over minimum threshold
2. Regional						
Specific regions with incentives	Rural areas eligible subject to 15% CIT.	Industrial Development Zones offer new investments fiscal incentives. New eligible firms receive tax free status.		Benefits available to EPZ enterprises include exemption for exise duties, exemption from corporation tax and withholding tax for 10 years, exemption from stamp duty, and a 100% investment deduction.		Rural areas eligible subject to 15% CIT.
3. Sector Specific						

Specific sectors with incentives	Mining (copper, cobalt) CIT 25%, agriculture 15%, nontraditional exports, 15%. Capital allowances especially in ag, tourism, manufacturing, (50% per annum). Duty exemptions for capital equipment imported by mining company. VAT zero ratings for exports, tour packages.	Capital allowances especially in agriculture, tourism, manufacturing; duty exemptions for capital equipment imported by mining company; VAT zero ratings for exports, tour packages; incentives for motor industry and textiles.	“Priority Areas” include processing of crops, forest products, meat and fish, banking, steel, chemicals, textiles and leather, oil milling, paper, mining, glass and plastic, ceramics, manufacture of tools, equipment and industrial spare parts, construction and building materials manufacture, tourism, real estate development, packaging, transport, energy conservation, pharmaceuticals, and high technology.	A 100% investment deduction is available on the cost of buildings and new machinery used for manufacturing purposes and hotels.	Investment allowances for priority and lead sectors (manufacturing, resources, financial services, transport, forestry, agriculture, high tech. Mining, tourism). All pay 30% CIT, but all receive 0 duty status for imported inputs, 100% capital allowance, VAT deferment or exemptions.	Basic rate: 35%, 25% for mining, 10% for manufacture in growth industries, 20 % other manufactures which export, 20% tourism
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1/Comparator country data obtained during desk study from International Bureau of Fiscal Documentation Country Reports, various years & should be used for reference only. Rwanda information is current as of September 2004 & does not include proposed incentive changes.

2/ All countries in this list have double taxation agreements.

4.1. South Africa

The standard rate under the corporate income tax is 29 percent.⁶⁵ In general, machinery is deductible straight line over a period of five years. However, for manufacturing, 40 percent of the cost of machinery is deductible in the first year, with deductions of 20 percent in each of the subsequent 3 years. Buildings in industries other than farming and mining are deductible straight line over a period of 20 years. It is not clear what deductions are available for buildings used in farming, so a METR is not calculated in this instance.⁶⁶ Farming development capital expenditures are expensed, while other expenditures are deductible according to the ordinary schedule, except for farming machinery which is deducted over three years (at rates of 50, 30 and 20 percent. Accordingly, and as in the analysis for Rwanda, the METR calculations assume that machinery in farming is deducted straight line over two years, reflecting a compromise between expensing and the other deduction schemes. A secondary tax on companies (STC) is also assessed on distributed dividends at a 12.5 percent rate. The METR calculations assume that this applies to half of earnings financed with equity, resulting in a 6.25 percent dividend distribution tax on investments financed with equity. A property transfer tax, generally at a rate of 10 percent for companies, is imposed on transfers of land and buildings.

4.2 Malawi

The standard corporate tax rate is 30 percent, with a 35 percent rate applied to foreign firms; the calculations for the financial services sector assume the latter rate applies. However, tax holidays are available in “priority” sectors, with a zero tax rate for up to 10 years and a 15 percent rate thereafter (20 percent for foreign firms). Priority areas include manufacturing, agriculture, and tourism.⁶⁷ Accordingly, the calculations in these three sectors assume a ten-year tax holiday, followed by a 20 percent corporate tax rate thereafter for manufacturing and tourism and a 15 percent rate for farming. Buildings are depreciated straight line over 20 years and machinery is depreciated straight line at rates that vary from 10-33.3 percent (and some machinery purchases in the agricultural sector are

⁶⁵ Rates on the mining sector range from 38-58 percent and small farmers are taxed at an 18 percent rate.

⁶⁶ A tax holiday program, available to selected projects with government approval, ended in 1999. Generous preferences are granted to firms pursuing “strategic industrial projects.”

⁶⁷ Tax holidays can also be granted to any “productive” sector and the length of the tax holiday may depend on the size of the investment and other factors, at the discretion of the Minister of Finance.

expensed), which is modeled as straight line depreciation over 5 years. Investments in machinery and industrial (but not commercial) buildings also benefit from a generous 40 percent investment allowance. Note that since all of these deductions fall within the tax holiday period, they have no effect on the calculations for the three sectors subject to the holidays. Any exemptions from customs duties or VAT on capital goods appear to be selective and are not considered in the analysis; however, to the extent that tax holidays in Malawi include such exemptions, the calculated METRs are overstated.

4.3 Tanzania

The standard corporate tax rate is 30 percent. Industrial buildings are usually depreciated straight line over a period of 20 years. Machinery is depreciated 50 percent in the first year and then at varying rates that will be modeled as a deduction of 25 percent each in years two and three. In addition, an investment allowance of 10 percent is allowed for purchases of industrial buildings, including hotels and most agricultural buildings. Some purchases of farming machinery and machinery for mining can be expensed; this is treated as increasing the deductions for farming and mining machinery to 60, 20 and 20 percent in years one through three.

The most striking feature of the tax system in Tanzania is an annual land tax that is imposed at an average rate of roughly 12 percent (although agricultural land appears to be subject only to a minimal land tax). If such a tax were effectively imposed at a rate of 12 percent, it would result in METRs well over 100 percent – all land rents would effectively be confiscated (and the taxpayer would still owe a significant additional tax liability). It seems unlikely that the tax is enforced in such a draconian fashion, but it is thus unclear how it should be modeled. In the absence of further information, the calculations ignore the land tax in Tanzania, but the potential existence of very high tax rates on investments in land (in industries other than agriculture) should be noted.

4.4 Zimbabwe

The standard corporate tax rate is 30 percent.⁶⁸ Taxpayers may either take deductions for straight line depreciation at fairly slow rates (2.5 or 5 percent for buildings and “just and reasonable” deductions for machinery) or take an initial allowance equal to 50 percent of the cost of the asset, spread equally over two years. Given the high rate of inflation in Zimbabwe (currently slightly over 50 percent), the latter approach would appear to be preferable for the taxpayer in most instances, and the calculations assume an allowance of 25 percent each in

⁶⁸ An additional “AIDS levy” of 3 percent of tax paid is not considered in the analysis.

the first two years of investments in machinery and “industrial” buildings used in manufacturing, tourism and agriculture. However, “commercial” buildings must be depreciated straight line over 40 years; this treatment is reflected in the METR calculations for investment in buildings in the financial sector.⁶⁹

⁶⁹ Additional incentives are available for investment in “growth point areas” and export processing zones.

Annex E: RRA Structure

1. **The Large Taxpayers Department** collects revenues from large private sector enterprises, including foreign-owned businesses: raises over 80% of tax revenues.
2. **The Internal Revenue Department** collects revenues from small and medium enterprises as well as individuals.
3. **The Customs and Excise Department** collects revenues emanating from import duties and taxes, including VAT. It is responsible for preventing restricted and prohibited goods from entering the country, processing of documentation on exports, facilitating transits, and controlling smuggling.
4. **The Revenue Protection Department** minimizes revenue losses by detecting and preventing external tax evasion, i.e. smuggling, as well as other forms of evasion occurring across all other departments.
5. **The Planning and Research Department** coordinates all planning and monitoring activities across the organization. It collects statistical information and issues a quarterly bulletin on revenues, analyses trends, reviews emerging policy issues, and advises MINECOFIN accordingly. It also acts as liaison with all external donors and other authorities in the region.
6. **Human Resources and Administration Department** manages all matters to do with the recruitment, development, promotion and retention of personnel, as well as personnel administration, including salaries and disciplinary matters.
7. **The Finance Department** is responsible for the accounting of all revenues and expenditures, and for preparing financial statements as required by law, is to assure financial accountability.
8. **The Information Technology Department** is responsible for the development and maintenance of IT across the organization, including introducing SIGTAS.
9. **The Quality Assurance Department (QAD)** has covered internal audit and the efficiency and effectiveness of business processes; Internal affairs investigates suspected corruption and malpractice, with the aim of improving staff integrity, and sensitizes staff on the code of conduct, conditions of service, etc; quality assurance unit focuses on improving service delivery and customer satisfaction.

10. **Policy Coordination Department:** is currently being established to standardize internal processes, taking over some of the duties of the QAD.

11. **Provincial Coordination Office:** to increase effective RRA coverage around the country.

Annex F: Macroeconomic perspective (or mix of tax instruments)

The strengthening of Rwanda Revenue Authority (RRA) over the last four years is remarkable and is evidenced by a 20 percent increase in revenue collected per year, from RWF 65 billion in 2000 to about RWF 135 billion in 2004.

Although, the set of tax instrument is consistent with the level of development of the country, Rwanda relies heavily on taxes on goods and services. As shown in Table 1 below, in the period 1998-2004, the share of such taxes in total tax revenue was 51 percent against 36 percent in South Africa; perhaps more comparable in 2004, it represented 50 percent against 41 percent in Zambia. In contrast, Rwanda is lagging behind in terms of direct tax revenue and in particular personal income tax revenue. For instance, direct tax revenues represented 31 percent of total tax revenue against 48 percent in Zambia in 2004. Therefore, a key challenge appear to rest in the expansion the personal income tax base, possibly through the formalization of the large non-monetized and informal sector, or through the promotion of the private business sector.

Table 1. Rwanda tax instruments and comparison with South Africa and Zambia

	Average 1998-2004		Year 2003	
	Rwanda	S. Africa	Rwanda	Zambia
Type of tax				
1. Direct taxes	29.5	59.9	30.6	47.6
1.1. Tax on income and profit	28.7	57.3	30.0	47.6
1.1.1. Companies	16.3	18.3	13.7	6.6
- Large companies	10.0		7.2	
- Small enterprises	2.5		3.3	
- Arrears	3.7		3.2	
1.1.2. Individuals	11.8	36.9	14.4	37.0
1.1.3. Others	0.5	2.1	1.9	4.0
1.2. Property taxes	0.8	2.6	0.6	
2. Taxes on goods and services	51.2	36.0	50.1	41.1
2.1. Excise taxes	20.3	10.7	14.2	13.0
2.1.1. Beer	8.4		5.2	
2.1.2. Wines & Liquors	0.4		0.3	
2.1.3. Petrol	7.5		5.7	
2.1.4. Cigarettes	1.7		1.4	
2.1.5. Lemonade	2.3		1.4	
2.1.6. Vehicles	0.0		0.1	

2.1.7. Powder milk	0.0		0.1	
2.2. Turnover tax / VAT	27.4	25.3	33.3	28.1
of which: on imports	16.1		16.9	17.5
2.3. Road Fund	3.5		2.7	
3. Taxes on international trade	19.4	3.3	19.3	11.2
3.1. Export tax	0.3	0.0	0.0	
of which coffee	0.3		0.0	
3.2. Import tax	15.2	3.3	15.7	11.2
of which surcharge on sugar	0.2		0.9	
3.3. Other (including Magerwa)	3.8	0.8	3.6	
Total tax revenue	100.0	100.0	100.0	100.0
<u>Memorandum (in 2004)</u>				
Grants in percentage of total revenue			46.5	17.1
Tax revenue as percentage of GDP, est.)			14.0	18.0

Source: Rwanda Revenue Authority, FIAS aide mémoire on South Africa, and FIAS report on Zambia

Corporate income tax revenue has declined as a percentage of total tax revenue. This appears consistent with the country's strategy of promoting private investment and economic growth through priority sectors: (...). Although large companies generate a small and declining share of total tax revenue, from 19 percent in 1998 to less than 5 percent in 2004, these companies generate the bulk (85 percent ???) of tax revenue, owing to their contribution to PAYE, VAT, excises, and import duties.

Annex G: Marginal Effective Tax Rates on Capital in Rwanda

Table A.7.1: Marginal Effective Tax Rate on Capital Investment in Rwanda, for Large Firms

Type of capital assets	Under The New Law										Under The Old Law				
	With 30% CIT, conditional investment allowance, and an undifferentiated annual depreciation allowance of 5% for both buildings and M&E										With 35% CIT, no investment allowance, and a depreciation allowance scheme based on the useful life of assets				
	With no investment allowance					With investment allowance									
	Manufacturing	Agriculture	Mining	Financial	Tourism	Manufacturing	Agriculture	Mining	Financial	Tourism	Manufacturing	Agriculture	Mining	Financial	Tourism
<i>Buildings</i>	21.9%	12.2%	19.3%	10.5%	13.5%	-5.3%	-13.8%	-7.7%	-9.0%	-12.7%	15.5%	4.4%	12.5%	2.5%	5.9%
<i>Machinery & equipment</i>	40.0%	44.5%	24.9%	71.0%	24.1%	12.5%	17.4%	-2.5%	67.5%	-3.3%	20.9%	30.3%	8.7%	70.0%	16.3%
<i>Land</i>	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-17.2%	-17.2%	-17.2%	-17.2%	-17.2%
<i>Inventories</i>	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-13.3%	-17.2%	-17.2%	-17.2%	-17.2%	-17.2%
Aggregate	29.0%	13.0%	15.3%	50.4%	13.6%	3.7%	-5.7%	-6.5%	43.6%	-10.8%	14.0%	3.1%	3.1%	48.0%	6.1%

Table A.7.2: Marginal Effective Tax Rate on Capital Investment in Rwanda, for Small Firms

Type of capital assets	For Small Firms Paying the 4% Turnover Tax					For Small Firms Paying the 4% Turnover Tax				
	Not registered for VAT hence unable to claim input credit under VAT					Registered for VAT hence able to claim input credit under VAT except for financial sector				
	Manufacturing	Agriculture	Mining	Micro-finance	Tourism	Manufacturing	Agriculture	Mining	Micro-finance	Tourism
<i>Buildings</i>	15%	12%	14%	12%	13%	15%	12%	14%	12%	13%
<i>Machinery & equipment</i>	26%	27%	16%	74%	27%	66%	67%	51%	74%	67%
<i>Land</i>	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
<i>Inventories</i>	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
Aggregate	19%	12%	12%	54%	15%	51%	32%	36%	54%	34%

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