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# TAXATION
# AND
# DEVELOPMENT INCENTIVES

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1. Introductory remarks - How honoured to be invited to introduce this week's Topic for Discussion.

2. Subject matter to be discussed - Taxation and Development Incentives.

The topic would appear to be two-legged: on the one hand there is the leg of taxation and on the other there is the leg of development incentives.

It would seem to me that the terms of the topic are aimed at making us look at how the two legs are linked namely: how a Government can use taxation policy so as to encourage economic development and what form or forms such encouragement can take.

a. What is taxation for?

(i) Basically to raise revenue.

(ii) Sometimes to stimulate growth - through protection/exemption.

(iii) Sometimes to regulate demand (through restricting or encouraging it).

b. What are development incentives?

Presumably measures taken by Government to generate and to encourage economic growth.

c. Sacrifice Revenue versus Development Incentives

Development incentives or fiscal incentives have somehow to be defined in terms of the revenue a Government has to sacrifice delibrately with a view to achieving some real or presumed economic benefit arising out of a particular investment.

The most important question therefore that springs to mind of those responsible for formulation of policy on fiscal incentives at all times is whether there is such real or presumed economic benefits and whether there are not already other factors which can attract investment without sacrificing revenue.

In other words the question put in a different form becomes a systematic evaluation of these factors which motivate a potential, local or foreign investor in reaching a decision to make a particular investment.

Authorities on this matter, people like S. R. Dixon-Fyle ( his paper on economic inducements to private foreign investment in Africa read at a seminar in the Department of Economics, University of Exeter which appeared in the journal Development Studies Volume 4, October 1967, No. 1) and the United Nations, Department of Economic and Social Affairs

conclusions and recommendations on Foreign Investment in Developing Countries would appear to leave it in doubt about what factors motivate in investors decisions.

To quote from the United Nations report on this matter:

"The precise effect of tax incentives in attracting investments which otherwise would not have been forthcoming - and, conversely, the revenue loss suffered where concessions were not needed - are as yet inadequately known. Such empirical enquiries as have been made to elucidate the actual inducement effect and over-all operations of various schemes confirm the expectation that, while prohibitive and discriminatiory taxes may effectively impede otherwise worthwhile investments, temporary exemptions from normal tax burdens are unlikely by themselves to constitute a determining factor in many investment decisions."

In other words tax incentives do not operate in a vacuum. They are part of what one might call a favourable investment climate and that climate consists of (1) Availability and location advantage of factors of production; (2) Political stability; (3) Availability of infra-structure services such as power, water, roads, telecommucication and air transport; (4) the market for the product to be manufactured, and (5) Estimated return on capital investment.

In my view fiscal incentives could only influence us to a large extent, the market for the product to be manufactured by creating a monopolistic situation and they can also influence the estimated return of capital investment through cash gifts by way of exemption or refund of taxes and only to a limited extent can they influence availability and location advantage of factors of production in so far as investment decisions go. I will say something more about this later on in my speech. All these considerations, however, make policy formulation in the matter of fiscal incentives become very delicate and one becomes less and less sure of oneself the more closely one looks at the expected economic return, the economy would reap in terms of fiscal incentives.

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3. <u>The forms in which development incentives are given</u>

Developing countries offer to foreign and domestic investors a remarkably wide range of fiscal incentives - these range from complete or partial exemption from profits, income and customs taxes; liberal depreciation concessions to tax holidays and complete assurance of market through protection of new enterprises.

Developing countries also provide indirect inducements in the form of guarantees of security of investment, guarantees of repatriation of profits and capital.

4. <u>Let us look at the East African situation vis-a-viz the rest of the world in terms of provision of fiscal incentives.</u>

In East Africa today we have fiscal incentives given through:

1. Customs tariff protection (this gives assured market) and refund of customs duty (this provides financial gift to the manufacturer).
2. Financial gifts known as income tax allowances on capital expenditure by way of what is known as investments deduction allowances under the second schedule, para. 27 of the East African Income Tax management Act.

   These investment deduction allowances were designed to bring about industrial development which would not otherwise have taken place. It is not a general allowance in respect of capital expenditure in every kind of business field. It is necessary to consider the kind of trade carried out and the nature of expenditure. In every case the claimant of the allowance has to show that he carried out the right kind of trade and that this related expenditure created a new industrial unit in that trade.

   Through these allowances investors write off in a fairly short period of time the capital expenditure of (a) industrial buildings (b) plant machinery (c) farm works (almost all capital expenditure incurred in agriculture) (d) mining (e) approved hotels and (f) scientific research.

There are also additional "once and for all" investment deductions for certain expenditure on ships, industry and hotel building and machinery.

Together with the above capital allowances the three East African Governments make the following concessions under our Income Tax Law;

(a) Income from outside East Africa is not taxed (to encourage residents' income from overseas).

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(b) The company rate is relatively lo--- only Shs. 8/- in the £.(40%).

(c) Dividends paid to non-residents out of taxed profits are subject to no further taxation (to encourage outside investment in local business).

(d) Lossess are available for carry forward indefinitely against future profits.

(e) For mining concerns, a special low rate of tax of Shs. 4/50 in the £ applies to profits from mining of special minerals; specified minerals are scheduled and are broadly those which are only marginally profitable.

Tax Holidays - I would now like to turn to some of the forms of fiscal incentives. To some people including some local and visiting economists there appears to be a gap in our fiscal incentives policy created by the Governments not according tax holiday reliefs or other additional generous tax exemptions to selected industries. Indeed there has been open criticism of Governments in this connection. The reason for the present policy stand appears to stem from the fact that given loss of revenue the Governments are not conveinced that tax holiday reliefs would apparently induce new economic benefits that would not otherwise have been acheeved through forms of tax reliefs already given. Furthermore a study carried out in South America and reported by the Harvard Law School in a book - Tax Incentives for Industry in developing countries (Page 120) came out with the view that the investigators in their research found that to a question "would you have started business without the availability of tax exemption?" replies were as follows:

Definitely 'Yes' ..........14
Probably 'Yes' .......... 9
Probably 'No' .......... 1
Definitely not or uncertain. None.

The authors go on to report that each of the 150 companies denied exemption in respect of 160 products between 1951 and 1955 proceeded to produce these products without the benefit of tax exemption. The conclusion they reached was as follows:-

"Thus although exemption have undoubt·'y been of substantial value to the fortunate recipients, the

extent to which they were necessary elements in investment decisions remains open to serious question."

In my former robes, I always was more impressed by industrialists who started business and sought protection/exemption afterwards and not before. Kenya firms are cases in point. As I have already indicated this is not an easy question in which one could be dogmatic in coming to an answer as to whether to give protection/relief/exemption. One has got to remember that unless the East African Governments had a whole renge of bilateral double taxation relief agreements with the foreign countries from which foreign investors came and under which there were tax sparing provisions and tax holiday that might be given to a foreign investor might not benefit that investor but instead benifit foreign Government Exchequers.

Furthermore one of the other reasons why tax holidays are meaningless is that most industries do not pay taxes during the first few years of their operations given liberal capital deduction and depreciation allowances. One can therefore reasonably ask why give double tax holidays then?

It would be interesting to find out from the discussions this afternoon what cogent arguments there are in favour of the introduction of tax holidays. It would also be interesting to find out how world wide tax holidays have not gained credit?

5. Disadvantages to be avoided in the implemention of fiscal incentives policy

As already mentioned incentives are designed to encourage investment aimed at producing certain products.

(a) Consumer interest should however be at all times safeguarded by very careful analy tic approach in the provision of tax incentives in the form of tariff protection and customs duty refund so as not to encourage high cost or uncompetitive industries. In this respect protection should be over limited periods of time and reviewable after each peri od.

(b) The tax payers interest must at all times be preserved by making sure that the loss of tax revenue is fully backed by real economic benefits to the economy through the incentives provided.

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Conclusions

a. Advantageous investment climate which can lead to economic development does not only consist of the provision of development incentives. There are other factors which must go in hand/with the provision of such incentives such as political stability; Government's cearly stated policy say regarding the role of the private sector vis-a-viz the public one; or regarding the role of foreign capital investment; and how the original capital when realised will be treated in terms of repatriation. Government instils more confidence among investors by adopting certain accepted international practices regarding investments disputes, for example, by adopting the international investments disputes settlement charter and by entering into effective co-operative agreements with foreign Governments under which those Governments insure their own investors against nationalization and other risks. Governments also improve the investment climate through the provision of certain basic intra-structure services as I mentioned which are more critical in determining the rate of return on capital to the investor.

b. Fiscal incentives should lead to real economic benefit to the economy and should not unduly increase the price to the consumer and should not in the long run lead to loss of revenue; there should be compensary effects on revenue growth.

c. Governments should make sure that the benefit arising out of tax exemptions accrue to the investor and not to some foreign Government Exchequer.

I would like to touch upon a more controversial area of the provision of fiscal incentives by pasing a question: What is the ideal form in which development incentives should be given? When Government gives up revenue in order to provide an increased economic return to an investor it directly enhences his income; at the same time it reduces the revenue available to Government for recurrent and development expenditure purposes. Government therefore has got to think in terms of either reduced expenditure levels or increased taxation or both. This tends to make me dislike tax reliefs or grants as forms of development incentives.

Furthermore it is usually difficult to determine the minumum and the maximum rate at which assistance should be given. This results in some investors gettingmore money than others depending on their respective efficiencies in the production process. The

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whole thing smacks of unfairness not only between two investors but also between investors and taxpayers. Some Governments have therefore tended to move towards straight grants relating to each industrial sector or towards loans and away from tax exemption. To me this move is in the right direction, as I have never approved of subsidies in principle. Whatever assistance that is given ought to be capable of general application with little discrimination. loans are less discriminating than grants and tax exemption and I am therefore for movement towards loans assistance. Furthermore loans have to be repaid and this makes me much happier in terms of allocation and utilisation of our limited resources; after all for business ought not to be turned into philanthropy.

Finally it must always be remembered that the foreign or local investor does not invest in Uganda or in any developing country through philanthropy but rather through shrewd business sense aimed at making him profit from the venture having taken stock of the whole situation. Before I conclude I would direct some questions to the seminar for discussion:

1. Should we treat local and foreign investors duly in terms of provision of fiscal incentives if so how and why?
2. Should fiscal incentives be standardized or personalized between industries and firms?
3. Given the different rates of growth within East Africa is it not injurious to the less developed for fiscal incentives to be standardized, is there not room for policy difference between the three Governments aimed at encouraging fast rates of growth in the lesser developed?

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