المرصـــد التـونسي للإقتصـــاد
Observatoire Tunisien de l'Economie

policy brief | n°12

Tax incentives, a loss of revenue for an uncertain benefit

Critical reading of the new law on tax incentives

Tunisian Observatory of Economy

19/11/2018

www.economie-tunisie.org

Abstract

The new project revising tax benefits generally renews a very generous incentive policy involving considerable revenue losses for the State. Despite the government's admission of failure regarding the incentive policy in place, the project is more in line with its continuity by targeting, simplifying and reducing tax benefits insignificant and renewing the logic according to which, the more generous the incentive policy, the more investors will invest. The benefit of this «loss of income» for the State is more than uncertain in view of the secondary role of tax incentives in the attractiveness of investments, the absence of more decisive prerequisites such as the qualification of the workforce and the quality of infrastructure, and also taking into account the regional and global context of tax competition. This equation is in fact more complex and the adoption of a generous tax policy not only results in significant tax expenditures but also redistributes the tax burden in a way that is detrimental to tax equity and justice.

Author :

Amine Bouzaïene
Policy Research Officer
amine.bouzaiene@economie-tunisie.org

Key words :

Tax incentive
Tax expenditers
Investment attractivity
Tax burden
Tax dumping

Recommendations

- On the methodological level :

- The reform of the law on tax incentives should be carried out as part of the discussions on tax reform.

- The discussion of the draft law revising tax benefits anticipates the reform of one of the components of the tax system. All national and international reports, including the diagnosis of the groups responsible for the tax reform project, agree on the inability of the current tax system to fulfil its financial, social and economic functions and, consequently, on the urgency of its total overhaul. The fate of the tax reform in question remains unknown. The early adoption of a law governing tax benefits will condemn tax reform either to amending them shortly after their adoption and will therefore send a message of instability and lack of credibility of tax legislation or it will tie the legislator's hands to the choices adopted in the context of this project.

It would have been necessary to accelerate the tax reform process and discuss tax benefits in this context, which would have provided an opportunity to initiate reforms to reform the parameters of tax competitiveness.

- The adoption of the five-year development plan and the setting of specific objectives and performance requirements must precede the adoption of the law revising tax benefits.

True targeting implies adapting the incentive policy according to the prioritization of the sectors of activity established as part of the development plan.

- On the provisions of the new law :

- Establish a mechanism for the conditional renewal of tax benefits linked to the achievement of objectives previously set by the State in terms of job creation, technology transfer, currency reserve, etc. Failure to meet the objectives will imply the non-renewal of tax benefits to its beneficiaries.

- In the event of its conviction by a final judgment relating to acts of tax fraud, it is necessary to provide for the deprivation of tax benefits and their full reimbursement, in addition to the penalties provided for in ordinary law.

- Eliminate the use of decrees and revert to a legislative incentive right in order to simplify and stabilize the incentive tax standard.

- Evaluate the tax benefits in terms of the cost/benefit ratio in an annual and public report in order to adjust and rationalize tax incentives.

- Initiate a real rationalization aimed at removing and reducing the excessively generous scope of tax incentives.

CC BY NC SA

Introduction

The Assembly of People's Representatives resumed discussions on the draft law on the revision of tax benefits at the beginning of 2017. This bill reforms and supplements the incentive system governed by the new investment code adopted in September 2016. Tunisia has thus adopted a new incentive system that will repeal the 1993 investment incentive code.

What is a tax incentive?

This is a tax reduction or exemption measure. It represents a derogation from ordinary tax law in that it is an exception to the tax norm of principle (for example, the tax norm of principle concerning the rate of corporation tax is 25%. The draft law on the revision of tax benefits increases this rate to 10% for the profits of companies working in the export sector).

What is the purpose of a tax incentive?

States use this tool to attract and direct investment according to their development strategy and objectives (research and innovation or installation and production to promote a specific sector such as renewable energy).

It is important to know that the implementation of a tax incentive policy dates back to 1958. This tax incentive scheme was not only maintained during the brief collectivization experiment but was even strengthened with the promulgation of an investment code on 26 June 1969. From the early 1970s, this arsenal of tax advantages was «consolidated» by a series of reforms instituting incentives for exports, services, manufacturing industries, mining, energy, the financial sector, tourism, etc[1].

Under the aegis of the international financial institutions (World Bank and IMF), Tunisia adopted the Structural Adjustment Plan in 1986. The first resulting reform in terms of incentives was the adoption of the Industrial Investment Code on August 2, 1987, establishing the principle of freedom of investment[2]. Still under the banner of economic liberalization, a new investment incentive code was adopted in December 1993 adopting the diagnosis and recommendations of international financial institutions, recommending that the incentive system be brought together in a single code and extending its scope to all sectors[3].

The multiplicity of tax benefits and the many changes that have been made to them have made the Tunisian tax system very complex.

According to the authorities, the current draft law on the revision of tax benefits addresses the shortcomings of the current incentive system. Through unpublished studies, the Ministry of Finance is proposing this draft law to address the complexity, low economic impact of current tax benefits and their general and insufficiently targeted scope.

Thus, in this Policy Brief, we will attempt to analyse the new tax benefits law and see whether it really constitutes a reform of the tax incentive policy in order to remedy the deficiencies mentioned above.

[1] The purpose of the then incentive regime was also to reassure the foreign investor by establishing the principle of non-discrimination between local and foreign investors (Article 5 of the former Investment Code). Incentives were also introduced on customs duties, registration fees, turnover tax, which were considered too heavy to attract investors.

[2] Before 1987, the benefit of the countless tax benefits introduced was subject to the condition of obtaining an authorization issued by the administration.

[3] With the exception of the financial sector, the mining sector and the energy sector, which remain subject to special laws, for reasons related to the particular nature of these sectors.

A minor reform of the tax incentive policy despite the announced reductions and adjustments

A weak rationalisation of tax benefits

Despite the attempts at adjustment and reduction, whether undertaken by the government or by the Finance Commission, the current project maintains a very generous incentive policy with regard to the objectives set.
The removal of some tax incentives, including tax incentives for vertical construction projects, university restaurants, reinvestment within the company or the office of tax supervision and assistance, among others, is insufficient to claim a real rationalisation of tax benefits (expression meaning the reduction of so-called benefits).
In fact, the current bill renews a very generous incentive arsenal. One example is the tax benefits granted for regional development. Article 64 of the new law exempts «totally from the personal income tax or corporation tax base any income or profits from business creation investments made in regional development zones» for periods of 5 or 10 years following the said zones.
Article 65 provides that even after the expiry of these exemption periods, investors will benefit from a deduction from the tax base of 2/3 of their income in respect of personal income tax or the preferential rate of 10% in respect of the corporate income tax.
Similarly, the generous regime granted to exporters has been extended in Article 67. The latter will benefit from the same tax advantages provided for in Article 65.

Random targeting of incentives in relation to development objectives

The objectives announced in the explanatory memorandum relating to this project are similar to those of the existing incentive scheme. Promoting investment, exports, agriculture, regional development and pollution control are all objectives set out in the existing tax benefits regime. In reality, the objectives have remained general in nature and the supposed targeting has resulted in the removal of some minimal incentives.
It is also noted that the discussions and adoption of the draft law on the revision of tax benefits preceded those of the five-year development plan. It is the prioritization of the business lines established under this plan that should normally be targeted by tax benefits. The methodological approach chosen already reflects the random scope of tax benefit targeting under the current bill.

- In order to ensure a better efficiency of tax benefits it is necessary to grant tax benefits by linking them to objectives in terms of employment, technology transfer, or even currency balance sheet as an example. These objectives will be adapted with the sectors of activity concerned and can also be set at the level of these sectors as is the case in Senegalese legislation or by beneficiary of the benefits. The latter possibility will allow the executive branch to adapt the objectives not only to the sectors of activity but also to the size of the companies and their ability to achieve their objectives.

- Meeting the objectives will lead to the renewal of tax benefits. Otherwise, the beneficiary of the tax benefits will simply be deprived of them.

The exorbitant cost of tax incentives: a loss of revenue for the State to be assessed

An exorbitant cost

Tax incentives are tax expenditures to the extent that they result in immediate losses of tax revenue to the state or local authorities. They result in a loss of income that would have resulted from the application of the tax standard in principle. Many States carry out an annual evaluation of all tax expenditures in terms of the financial cost to the State coffers. The United States was the pioneer in this field. Today, a very large number of countries are evaluating tax expenditures, including Australia, France, Spain and Japan. African countries include Senegal and Morocco, which have been assessing the cost of tax incentives for the past 12 years.

Tunisia, for its part, despite the importance and generosity of the tax benefits it has always provided itself with and intends to renew, has no obligation on the State to carry out an evaluation until now.

Nevertheless, some studies and surveys provide a fairly rough idea of tax expenditures in Tunisia. In a publication entitled «Review of investment incentives in Tunisia»[4], we compared the results of three recent studies from the Tunisian academic community (Kamel Ghazouani, 2011), the Tunisian administration (ITCEQ, 2012) and the World Bank (IFC, ECOPA - a firm mandated by the IFC, 2012) and we showed the cost of tax incentives for the period from 2002 to 2011.

[4] Chafik Ben Rouine, L'Observatoire Tunisien de l'Economie, link : http://www.economie-tunisie.org/fr/observatoire/analysiseconomics/bilan-incitations-investissements-tunisie

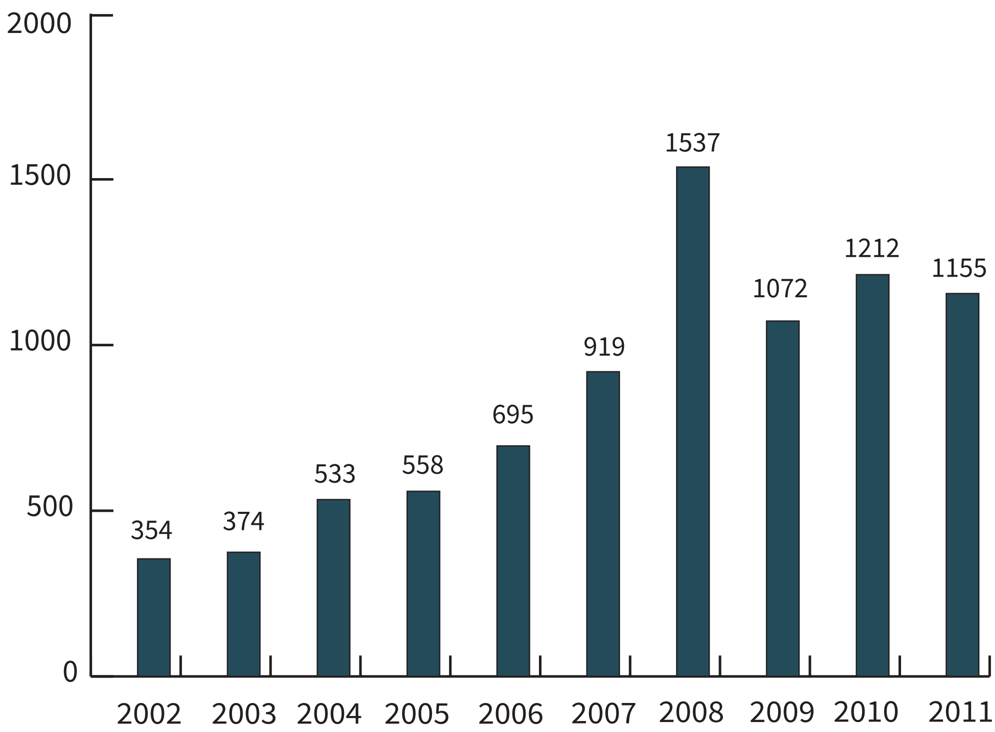

Figure 1 : Gross tax deductions (in million dinars) ECOPA - 2012
Source : Assessment of investment incentives in Tunisia - TOE - 2014

This shows that tax incentives result in an exorbitant cost: over this 10-year period, the average tax incentive represents 70% of corporate tax revenue.

At the level of total tax expenditure, export tax incentives represent 83% compared to 6% for regional development and only 1.6 for agricultural sector development.

During the Ben Ali era, financial need dictated that the government reduce these tax benefits. To cope with the widening budget deficit, post-revolution governments continued to build on this momentum[5]. This reduction is in fact extremely low and the cost of these benefits is estimated at 1129 million dinars in 2014[6], i.e. 140% of the budget of the Ministry of Finance, whose tax administration suffers from a serious lack of human and material resources.

The current tax benefits review project, while continuing this rationalization approach, continues to adopt a very costly set of tax incentives, the assessment of which is a key requirement.

[5] - Article 45 of the Finance Act for 2012.
- Article 37 of the Supplementary Finance Act for 2012.
- Articles 48 and 54 of the Finance Act for the year 2014 ect.

[6] Hearing of the Minister of Finance at the Finance, Planning and Development Committee of the Assembly of People's Representatives, on 03/01/2016, Bawsala website, link, http://majles.marsad.tn/2014/fr/chroniques/586bcbe9cf44121f3e63b030

The need to establish a regular assessment of the cost of tax incentives

It is strongly recommended that a mandatory and regular cost assessment be carried out given the large losses in tax revenue caused to Tunisian citizens. In view of its functions and the database at its disposal, the Ministry of Finance seems best placed to carry out this evaluation. This may take the form of a public annual report annexed to the draft finance law. This report will initiate discussions on the budget by having accurate data on one of the significant government expenditures resulting from these tax benefits.

It is also recommended not to focus solely on financial considerations in the evaluation. Indeed, the report must also assess the impact of these tax benefits in the light of their objectives, namely, the impact on exports, job creation, technology transfer, research and development, etc.

In this way, the public authorities will have a clear and transparent overview of all tax expenditure with a positive impact and its evolution, but also of all tax expenditure that has no impact and whose abolition would result in probably very significant savings.

Our recommendation was adopted by the ARP on February 1, 2017[7]

[7] https://www.facebook.com/ObsTunEco/photos/a.137749386390379.32463.137501783081806/736296026535709/?type=3&theater Our recommendation on the report on the evaluation of tax and financial incentives was finally adopted by the Assembly of People's Representatives.

A rigorous targeting of tax incentives is necessary because of their uncertain effectiveness

Tax incentives alone do not define the attractiveness of a country's tax system

Indeed, it would be wrong to reduce tax competitiveness, i.e. the attractiveness of a country's tax system, solely to the tax exemptions and reliefs provided for in tax legislation. The stability and simplicity of the tax standard, the transparency of the tax system, the guarantees of the taxpayer before the administration, the fluidity and efficiency of tax litigation, payment methods, base rules, etc. are all elements that are taken into account in tax competitiveness and of which Tunisia is seriously behind. Of all these factors, we will focus on the issue of simplicity and stability of the tax standard.

• The simplicity and stability of the incentive tax standard:

On this point, the draft law on the revision of tax benefits failed to take stock of the incentive mechanism provided for by the former investment incentive code despite the announcement of the objective of simplification through this draft law.

The latter has addressed only one aspect of complexity, related to the scattering of incentive legislation, by proposing to include them in the general codes, pending the establishment of the general tax code, provided for in the context of the tax reform.

• The imperative to break with the delegation to decrees, a major cause of the complexity and instability of the law of incentives

It should be recalled that one of the fundamental reasons for the adoption of the 1993 investment incentive code, according to the public authorities themselves and the recommendations of the international financial institutions, was the homogenization of the pre-1993 incentive regime and its simplification. The result was an even more complex and scattered tax system and incentive system.

Before the Investment Incentives Code, the law on incentives was legislative, in the sense that it was only the law that regulated incentives. After 1993, a two-tiered legislative and regulatory incentive fee was introduced. Both the code and the decrees resulting from it have been amended at an unreasonable pace.

The successive amendments have therefore contributed to the complexity of incentive law[8] but have also affected a factor, just as important in the attractiveness of investments, which is the stability of the tax standard[9].

It is surprising that this blatant observation[10] was not taken into account in the new draft revision of the tax benefits, so that the draft decree implementing Article 63 of the draft law had already undergone a change while the draft law was still under discussion in the committee, causing several members of the committee to be amazed. The decree in question must define the two groups of regional development areas and even appropriates the decision-making power with regard to the activities that will be excluded from the benefit of tax benefits for regional development. The reference to the Decree is therefore likely not only to make the incentive regime more complex, but also to provide an easier framework for amending it, thus contributing to the instability of the tax standard. By way of comparison, the first decree implementing the code establishing the incentive zones was issued on 14 February 1994. This Order was amended five times before being repealed and replaced by a new Order in Council dated March 1, 1999. During its period of validity, the Decree of 14 February 1994 was amended on average once a year.

Even if such a pace of amendment is difficult to explain, delegation to decrees gives the executive power easy ground for amendment and ultimately contributes to the complexity and dispersal of incentive law and its ultimate instability.

• It is therefore imperative to take into account the flagrant failures of the 1993 incentive law and to revert to a legislative incentive mechanism in order to ensure simplification and stabilization of the incentive standard.

Tax benefits, a secondary factor in the attractiveness of investments :

The draft law on the revision of tax benefits marks a continuity in the policy of attracting investment by focusing in the first instance on a generous incentive policy. In this context, it would be wise to consider the various parameters that have an impact on the attractiveness of investments.

Studies and surveys on this subject are abundant and unanimous. It is clear from this that tax incentives are a weak determinant in the decision to invest in a particular site.

Professor Habib Ayadi states that «... profit opportunities, political stability, historical ties, geographical location, facilities, infrastructure, concern for a skilled workforce,

[8] Barely 8 years after its adoption, the 1993 Incentive Code has undergone eleven direct changes. With regard to the question of delegation, it should be noted that the 1993 Code, in its 67 articles, made 55 references to decrees for its implementation. The executive branch has issued 37 regulatory decrees pursuant to the Code, which are currently in force. Some decrees issued pursuant to the Code have been repealed and replaced by other decrees. In addition, there are the individual decrees adopted pursuant to Article 52 of the former Code, the number of which was increased to 40 at the end of 2000. In addition, these same decrees implementing the investment incentive code have been amended at an abnormally high rate.

[9] As of 31 December 2001, it has been possible to identify at least seventy-five changes. One of these decrees alone was amended 13 times. Source, idem

[10] «The investment law in force until 1993 was certainly characterized by its fragmentation (some fifteen laws and a few disparate provisions in the finance laws). But this right was basically a legislative right, which gave it a certain solemnity and homogeneity due to parliamentary procedure, which imposes a minimum of serenity in the design of texts in order to have them accepted by parliamentarians. However, since 1993, when the investment incentive code was promulgated, we have had to note that the legislation on investment incentives is more heterogeneous, more complex and more unstable. There has been a real delegalization of investment law. This delegation has made this right even more diffuse and unnecessarily more complex than previous legislation. »

new opportunities and improved productivity are all decisive factors before tax relief»[11].

According to the results of the above-mentioned survey, conducted by the IFC (World Bank Group) in 2012, almost 90% of the investors surveyed would have invested even without the tax and financial benefits.

Considered an unstable and changing factor by investors, tax benefits can be reviewed by governments, especially in developing countries where the search for additional revenue can lead them to rationalize their tax benefits[12]. In addition, tax competition between States aimed at attracting investors by granting them the most generous tax incentives and the most attractive tax rates has made the tax parameter less decisive in the eyes of investors.

A study by the World Bank[13] shows that the attractiveness of tax benefits decreases even more in countries where the most important parameters mentioned above, such as infrastructure or the quality of the workforce, are lacking.

Moreover, in Tunisia, tax incentives have not resulted in a substantial increase in investment, particularly FDI. Moreover, this is also the case for African countries in general. Studies on the subject show that 70% of FDI flows circulate in OECD countries. On the other hand, the flow of FDI outside OECD countries is very concentrated. «The ten main recipients of the capital are as follows: Argentina, Brazil, Chile, China, India, Indonesia, Korea, Malaysia, Mexico and Thailand. Little capital goes to Africa and inflows are limited to a few countries with significant natural resources.»[14]

- It would therefore be preferable for Tunisia to invest in the most important parameters given the delay it is experiencing at these levels, in particular by reconsidering very expensive tax expenditures. The revenue shortfall they generate could be reinvested in improving poor infrastructure and reforming the education and vocational training system by adapting it to the needs of the labor market[15].

[11] Ayadi (H), « Droit fiscal », publication du centre d'études, de recherches et de publication de l'université de droit d'économie et de gestion de Tunis, 1989, p538. In the same way see:
- Fouchard (Ph), « Les garanties juridiques accordées aux investissements étrangers en Tunisie », RTD, 1980, p49.
- Gouthière (B), «Les impôts dans les affaires internationales » : trente études pratiques, Francis Lefèvre, 1989, p135.
- Martinez (J-Cl) et Dimalta (P), Droit budgétaire, Paris, Litec, 3ème éd, 1999, p87.

[12] «The temporary nature of tax incentives is not hypothetical. All States are engaged in the perilous exercise of challenging tax benefits. «Baccouche (N), Investment Incentives and Competition between States.

[13] Ministry of Finance website, http://www.finances.gov.tn/assises_fiscalite/pdf/3-Tunisia_Tax_incentives_Sept2014_final_(short).pdf

[14] Bernard PLAGNET, Les facteurs de compétitivité fiscale d'un pays, Etudes Juridiques, (Revue de la Faculté de Droit de Sfax, n° 10) 2003, p. 9 et s.

[15] Indeed, studies indicate that countries with developed infrastructure and skilled labor are more productive. «In Malaysia, Taiwan and the Southeast Chinese provinces, foreign direct investment stimulates productivity. In contrast, the studies on Morocco, Tunisia and Uruguay do not conclude that the benefits are similar. In fact, there is some evidence that the entry of foreign firms does not translate into knowledge-related benefits for local firms that can be provided by new entrants. On the contrary, they suffer a loss of market share, and the resulting decline reduces their productivity. Within a country, companies with superior research and development capabilities are more likely to benefit from the advantages of foreign firms.» Source: Idem.

The negative consequences of States' recourse to a generous tax incentive policy :

The inequitable redistribution of the tax burden

The consequence of the granting of significant tax benefits and the imprudent reduction of tax rates is the inequitable redistribution of the tax burden. The continuous reduction in corporate income tax, and the granting of tax exemptions or tax relief both for direct taxes and indirect taxes such as VAT, lead to offsetting tax revenue losses through the redistribution of the tax burden.

While this phenomenon even concerns OECD countries, the situation is worrying in Tunisia, where the tax system is characterized by high inequity.

The taxation of wages, through the withholding tax technique, increases the contribution of employees to 80% of income tax revenues, while tax revenues from corporate profits have fallen to only 23% of tax revenues from direct taxes.

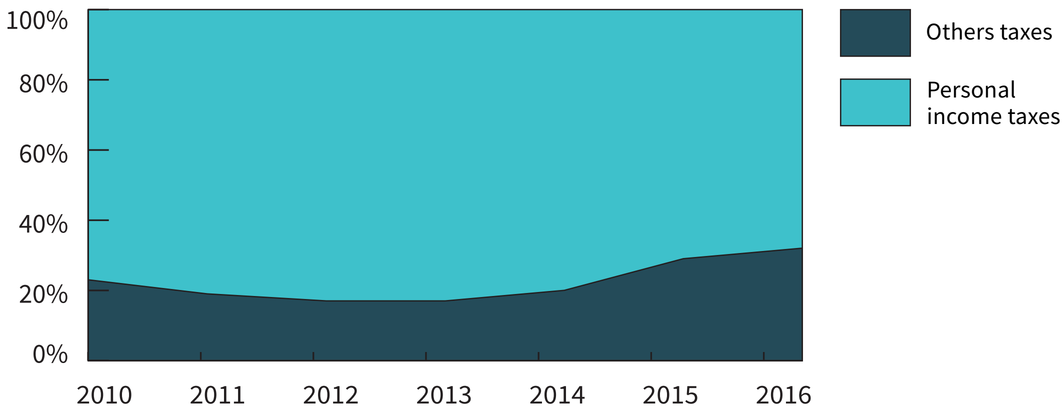

Figure 2 : Evolution of personal income taxes from 2000 to 2016
Source : Ministry of Finance

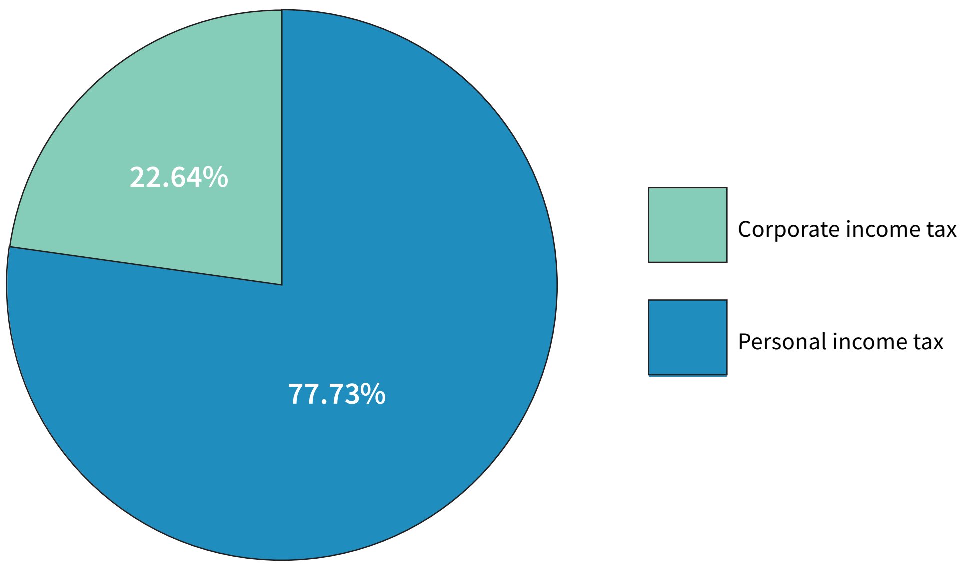

Figure 3 : Direct taxes structure
Source : Finance law of 2017 - Ministry of Finance

On the other hand, 59% of tax revenues come from indirect taxes, the unfairness of which is undeniable.

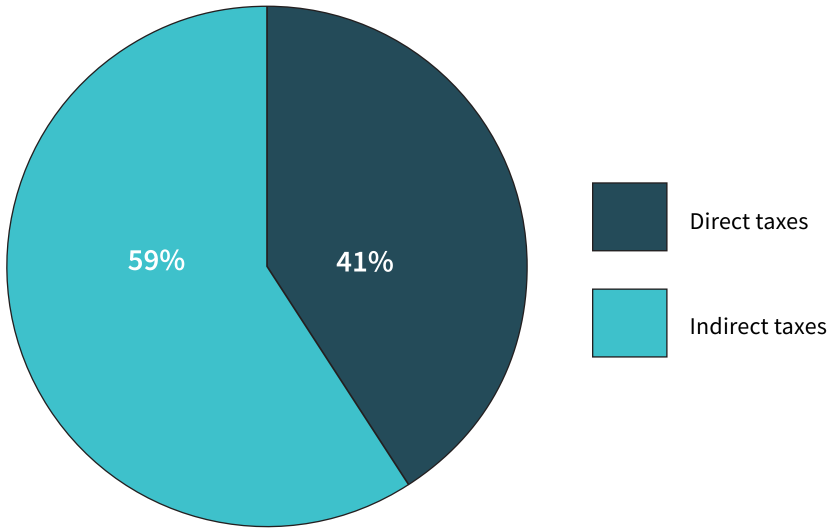

Figure 4 : Tax incomes structure
Source : Finance law of 2017 - Ministry of Finance

Harmful tax competition

The reduction of tax rates to attract investors is achieved both through the standard, by reducing corporate tax rates and through the adoption of tax incentives. This tax competition from States through the generosity of tax incentives to attract investment leads to very harmful tax dumping. Indeed, this has resulted in the birth of tax havens and the proliferation of tax evasion and avoidance. Lost revenues handicap public finances and particularly those of developing countries. This fiscal overbid inevitably condemns the public authorities to reduce public spending to the detriment of public services, investment in infrastructure and so on.

Tax harmonization treaties must be requested by Tunisia and ambitious efforts must be made by Tunisian diplomacy to push for tax harmonization at a Maghreb level in the first instance.

Bibliography

Ayadi (H), « Droit fiscal », publication du centre d'études, de recherches et de publication de l'université de droit d'économie et de gestion de Tunis, 1989.

Baccouche (N), Incitations aux investissements et concurrence entre Etats, Revue tunisienne de Fiscalité, 2006.

Baccouche(N), « L'environnement fiscal de l'entreprise à l'heure de l'internationalisation de l'économie : le cas de la Tunisie », Revue études juridiques, N°10, 2003.

Ben Rouine (C), « Le coût des incitations à l'investissement », Site de l'Observatoire Tunisien de l'Economie. http://www.economie-tunisie.org/fr/observatoire/analysiseconomics/bilan-incitations-investissements-tunisie

Chahmi (T), « Les incitations fiscales à l'exportation après la promulgation du code d'incitations aux investissements » Mastère Droit des affaires, facultés des sciences juridique, politiques et sociales de Tunis, 2009.

Fouchard (Ph), « Les garanties juridiques accordées aux investissements étrangers en Tunisie », RTD, 1980.

Gouthière (B), «Les impôts dans les affaires internationales » : trente études pratiques, Francis Lefèvre, 1989.

Martinez (J-Cl) et Dimalta (P), Droit budgétaire, Paris, Litec, 3ème éd, 1999, p87.

PLAGNET (B), Les facteurs de compétitivité fiscale d'un pays, Etudes Juridiques, (Revue de la Faculté de Droit de Sfax, n°10), 2003.

The World Bank :
- IFC report, ECOPA, 2012.
- Tax incentives, cost-benefit and global experience, 2014. Link : http://www.finances.gov.tn/assises_fiscalite/pdf/3-Tunisia_Tax_incentives_Sept2014_final_(short).pdf

Ministry of Finance website : http://www.finances.gov.tn/

This publication is done in the framework of a joint project with Tax Justice Network – Africa and is funded by NORAD.

المرصد التونسي للإقتصاد
Observatoire Tunisien de l'Economie

contact@economie-tunisie.org
www.economie-tunisie.org
www.twitter.com/ObsTunEco
2 Moussa Ibn Nousayr Street, Belvedere -1002-Tunisia
www.facebook.com/ObsTunEco
(+216) 71 844 039