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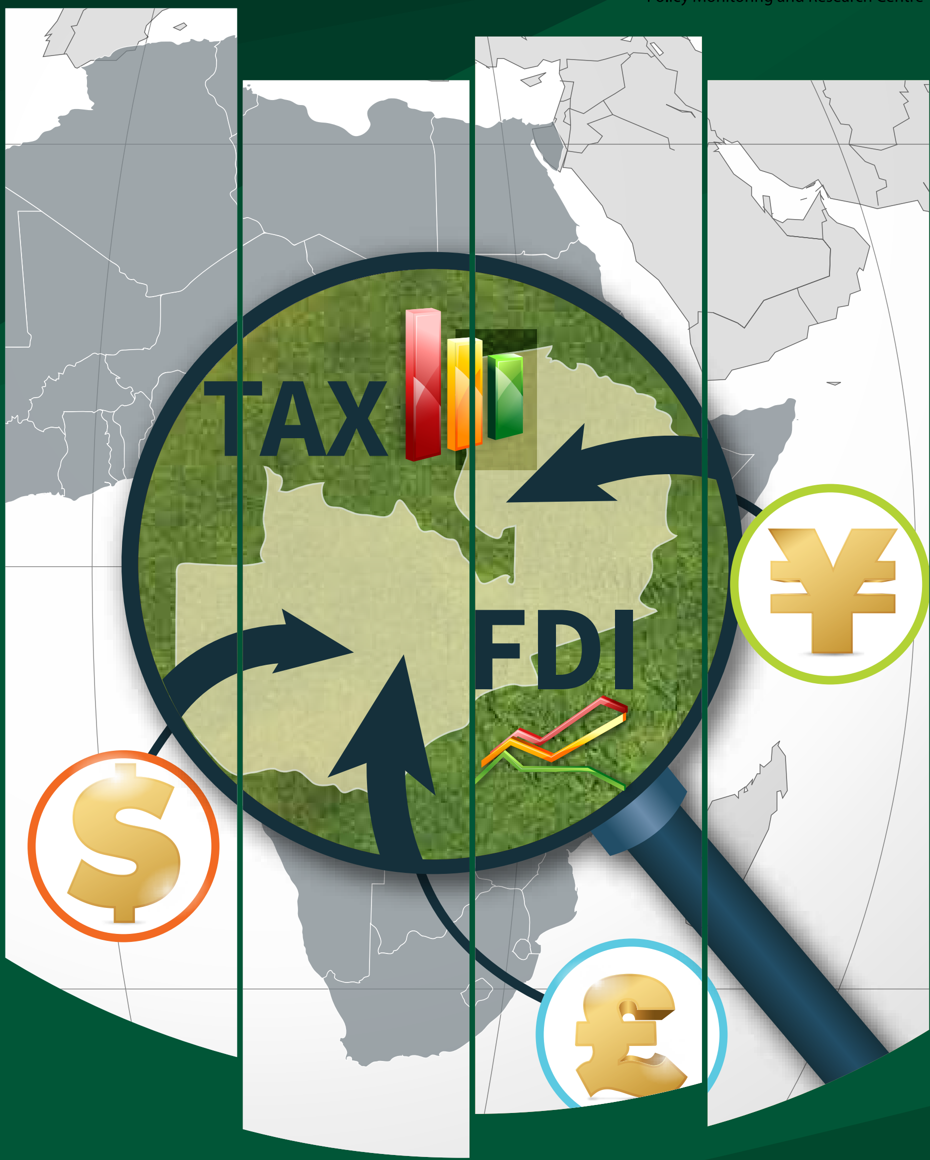

PMRC TAXATION SERIES

THE ROLE OF EFFICIENT TAX INCENTIVES IN ENHANCING INVESTMENT

POLICY BRIEF

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ABBREVIATIONS

BEFI	Business Entity with Foreign Investment
CIT	Corporate / Company Income Tax
CoF	Certificate of Registration
DRC	Democratic Republic of Congo
EBZ	Export Board of Zambia
FDI	Foreign Direct Investment
IMF	International Monitory Fund
IPC	International Procurement Centre
MFEZ	Multi Facility Economic Zone
MIDA	Malaysian Industrial Development Authority
MoFNP	Ministry of Finance and National Planning
MSC	Multimedia Super Corridor
OHQ	Operational Headquarters
PB	Policy Brief
PMRC	Policy Monitoring and Research Centre
PSDRP	Private Sector Development Reform Program
RDC	Regional Distribution Centre
SADC	Southern African Development Community
SAP	Structural Adjustment Policy
SI	Statutory Instrument
SME	Small Medium Enterprise
SMI	Small Medium Industry
TPRC	Tax Policy Review Committee
ZDA	Zambia Development Agency
ZEPZA	Zambia Export Processing Zone Authority
ZIC	Zambia Investment Centre
ZPA	Zambia Privatization Agency

PMRC TAXATION SERIES

THE ROLE OF EFFICIENT TAX INCENTIVES IN ENHANCING INVESTMENT

KEY MESSAGE

Tax incentives[1] are tools used increasingly by many developing countries to attract Foreign Direct Investment (FDI) and promote economic growth. FDI is key to national development and efforts to attract such investment are critical components of Government planning and thus tax incentives are preferred. There has been considerable debate on the extent of emphasis that should be placed on tax incentives and how important they are in attracting foreign investment. However there are general agreements that tax incentives can play a central role, with their success dependent on methods of administration.

Tax incentives are offered to investors in Zambia through the Zambia Development Agency (ZDA) a quasi-government institution legally mandated to promote investment, and administered in collaboration with other government agencies. However there is no single policy guiding the administration of tax incentives, posing a challenge to their effectiveness and limiting coherence and consistency in the process.

The tax incentives offered in Zambia are generally broad, and not specifically adapted or tailored to meet Zambian investment requirements. This has resulted in key sectors being left out, such as the Small and Medium-Sized Enterprises (SMEs). Additionally, there is no public information on the costs of these incentives or the loss in revenue, ultimately affecting the integrity and transparency in the provision of these initiatives. A comprehensive cost-benefit analysis needs to be undertaken and the losses in revenue due to incentives made public.

Tax Incentives can be defined as special exclusions, exemptions, or deductions that provide special credits, preferential tax rates or deferral of tax liability

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Summary

This Policy Brief (PB) describes the current tax incentive regime; the processes involved in the issuance of tax incentives, and the institutional arrangements that facilitate for the implementation of various administrative roles and tasks. The administration of tax incentives is critical to the performance and success of these incentives thus it is important to understand the processes involved.

The Brief explains how tax incentives are administered in other countries that have similar socio-economic conditions to Zambia. It focuses on how incentives have been designed to suit the particular country and economy, and meet national development goals. In this policy brief, PMRC suggests that the current Zambian tax incentive regime should be redesigned so as to suit and address investment in the Zambian context.

PMRC further urges for the creation of an Investment Policy that clearly defines the investment goals of the nation and provides direction to the tax regime. The current tax incentive process involves too many institutions, ultimately raising the cost of doing business, and subjecting investors to uncertainty due to discretionary powers held by some institutions. An Investment Policy would outline the processes involved in the issuance of tax incentives and harmonise the administration process.

Background

History of Tax Incentives in Zambia

The utilisation of incentives as a tool to enhance investment has become increasingly popular among developing countries over the last two decades. Tax Incentives can be defined as special exclusions, exemptions, or deductions that provide special credits, preferential tax rates or deferral of tax liability. Tax incentives can take the form of tax holidays for a limited duration, current deductibility for certain types of expenditures, or reduced import tariffs or customs duties.[2]

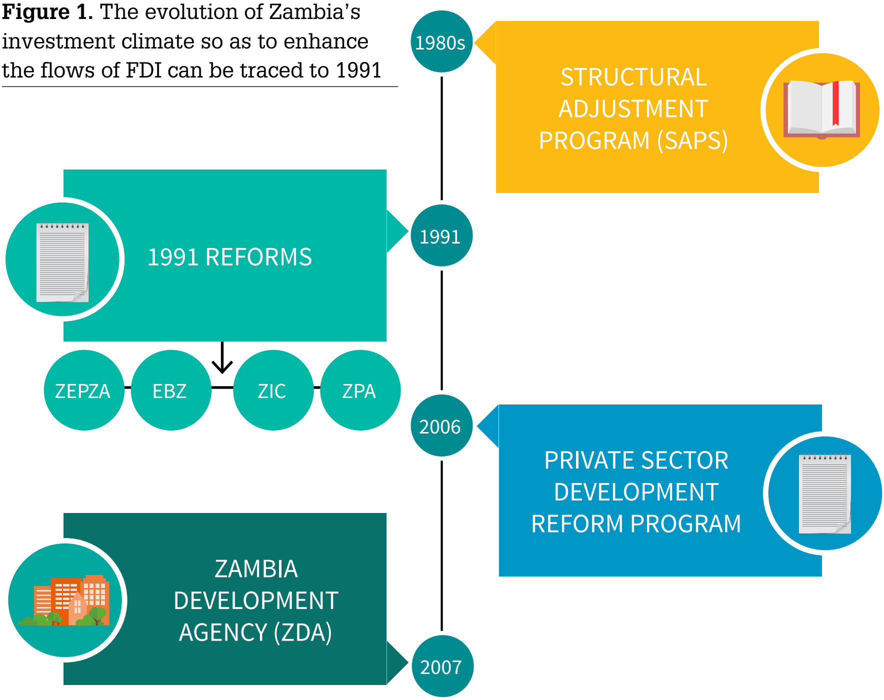
Given the underlying goal of tax incentives in attracting FDI, it is important to consider trends relating to foreign investment. These can act as an indicator or measure of success and impact of tax incentives, illustrating to what extent incentives have been effective in facilitating an enabling investment environment and promoting economic growth. Over the years Zambia has made enormous strides in becoming a suitable destination for FDI. The 1980s were characterised by the near collapse of the economy due a sharp decline

2. Easson and Zolt, 2002 TAX INCENTIVES World Bank Institute

in copper prices, significantly affecting the largely mining driven economy at the time. The economy was liberalised in the early 1990's in efforts to help the economy recover as well as open the economy to Foreign Direct Investment.

This began with the creation of the Zambia Investment Centre (ZIC), the first formally established investment promotion agency established under the Investment Act of 1991. This was the first time that tax incentives were formally introduced in the Zambian Economy. ZIC was formed as part of the countries Structural Adjustment Program (SAP) and liberalization process. With the opening up of the Zambian economy in the 1990s, FDI inflows increased considerably reaching $334 million in 2004.[3]
During the 1991 reforms other institutions were formed to support the objectives of the SAP. The Export Board of Zambia (EBZ), the Zambia Privatisation Agency (ZPA), and the Zambia Export Processing Zone Authority (ZEPZA) were all created with the aim of promoting trade and investment. ZIC was later merged with four other statutory bodies to form the Zambia Development Agency (ZDA) through the enactment of the ZDA Act No.11 of 2006 as a result of the Private Sector Development Reform Program (PSDRP).[4]

Figure 1. The evolution of Zambia's investment climate so as to enhance the flows of FDI can be traced to 1991

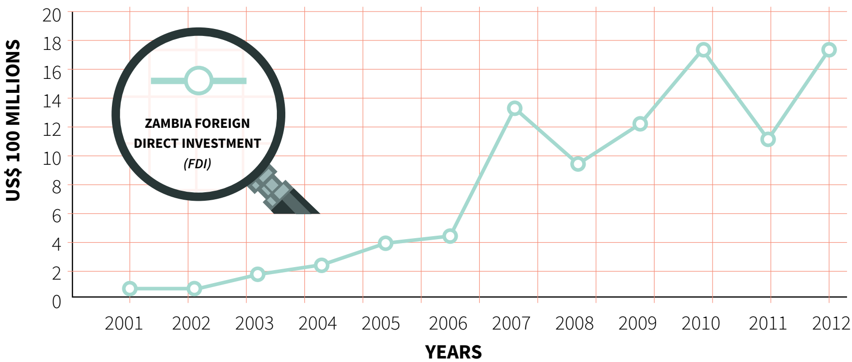


3. Investment Policy Review Zambia, UNCTAD 2006
4. Highlight of the Policy Framework for Investment in Zambia, April 2011

The main function of ZDA is to promote efficiency, investment and competitiveness among businesses in Zambia. Part VIII of the act empowers ZDA in consultation with the Ministers in charge of Commerce and Finance to offer incentives to investors.[5]

Since the creation of ZDA in 2006, FDI has almost tripled from US$ 467 million in 2006 to US$1,323 million in 2007, however, this has stabilized overtime.[6] This provides an opportunity to review the tax incentive system so as to ensure that the flows of FDI continue to grow at a rate that matches that of projected economic growth.

Figure 2. Zambia FDI flows 2001-2012

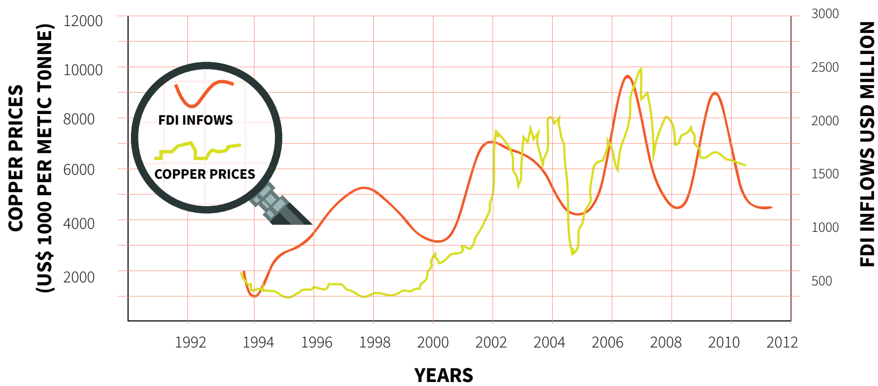


Source: PMRC adaptation World Bank Country statistics (Zambia) [2001 - 2012]

Whilst FDI provides a useful indicator of the effectiveness of tax incentives, there are a number of other, external factors that may influence FDI, such as the political environment, economic stability, and global market trends. The Zambian economy is extremely reliant on the performance of its mining industry, and trends in the flows in FDI have mirrored the performance of the mining sector and copper price fluctuations. Figure 3 illustrates how Zambia's FDI inflows and world copper prices have historically been linked.[7] Copper has played an important role in economic development in Zambia but with copper prices determined externally it thus becomes a challenge to significantly influence flows of FDI through policy mechanisms. However with governments' will to diversify the economy, there is an opportunity to formulate policies that would boost non-copper FDI that is not vulnerable to external forces. These policies need to be coherent and consistent in order to successfully stimulate the flow of FDI.

5. ZDA Act No.11 of 2006
6. World Bank http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD
7. Investment Policy Review Zambia, UNCTAD 2006

Figure 3. FDI inflows Vs. Copper Prices for 1994-2012



Source: and UNCTAD PMRC adaptation

Pre-existing Challenges

The creation of ZDA brought with it many questions about the effectiveness of the tax incentives, specifically relating to issues of policy coherence and administration. Key challenges relate to the following:

- Lack of targeted incentives
- Lack of employment and economic growth benefits
- Unrealistic investment costs for local investors
- Lack of consistency in supporting policies
- Erosion of the tax base

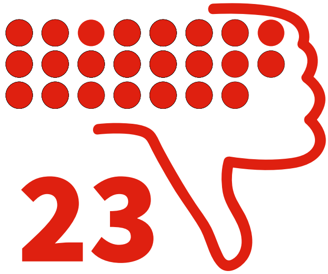
Lack of Targeted Incentives

The need for targeted incentives is very important. Targeted incentives serve two main purposes. Firstly, they indicate the types of investment that host governments seek to attract. Secondly, they reduce the cost of incentives and this reduces tax expenditure, increasing available funds for government activities.[8] Tax incentives should be designed only to target specific growth sectors identified by government. Targeting of incentives also implies that they should not be extended to sectors that are already “profitable” and

8. Easson and Zolt, 2002 TAX INCENTIVES World Bank Institute

should only be limited to correcting market failures as well as boosting specified growth sectors. Currently the opposite has been ongoing with the proliferation of tax incentives. The ZDA Act Section 82 allows for the minister after consultation with ZDA to make amendments to the schedule and regulations pertaining to priority sectors. In 2006 during the enactment of ZDA, only 12 priority sectors where identified, over time with the issuance of Statutory Instruments this has increased to 23 sectors.[9] The implication is that the tax incentives are now offered in general and not targeted to promote identified growth sectors calling into question their efficiency.

12 PRIORITY SECTORS
2006



23 PRIORITY SECTORS

2014

Unrealistic Investment Costs for Local Businesses

It is worth noting that the tax incentives offered by ZDA do not discriminate between local and foreign investors. The Act does however prescribe conditions that must be met before an investor can access these incentives; the most contentious of these being the requirement for a minimum capital investment of US$500,000.[10] The private sector argues that this requirement rules out the possibility of local investors accessing these incentives because of the lack of access to capital finances. They further argue that this makes them less competitive than the foreign investor as the incentives significantly reduce the operation costs of foreign investors.[11] This has also led to a general perception that incentive system is structured to favor foreign investors at the cost of local investors.

9. "Zambia. Further Proposals for broadening Tax Base," IMF July 2013.
10. ZDA Act No. 11 of 2006
11. Key Informant interview with Mr. P. Tembo of the Zambia Chamber of Commerce and Industry (ZACCI)

Erosion of the Tax Base

Conventional literature emphasizes that tax incentives, increasingly introduced through statutory instruments, often erode the tax base without any substantial effects on the level of investment.[12] The International Monetary Fund (IMF) have estimated that statutory instruments relating to indirect taxes in Zambia resulted in the loss of approximately US$ 175 million in 2012, equivalent to 1.41% of GDP. In the same report from IMF also noted that the cost of the tax holidays could not be quantified and has led to poor performance of Zambia's Corporate Income Tax (CIT), which is below the SADC average. This implies that there has not been a cost benefit analysis of the impact of tax incentives on the economy.[13]

1.41% GDP / **US$175 Million** LOST IN 2012.

Lack of Employment and Economic Growth Benefits

The Zambian Minister of Finance during the 2014 Budget Address highlighted that tax incentives offered to investors have not yielded tangible benefits in the form of employment. This brings into question the effectiveness of incentives in stimulating the balanced growth of the economy. The statement further reiterates the need for a comprehensive review of tax incentives as well as the need to strengthen the monitoring and evaluation of the provision of incentives.

> *"Sir, you recall that in my Budget address to this House last year, I made reference to our tax incentive regime as being one of the most generous in the region. However, studies undertaken to examine the extent to which investors accessing tax incentives, have met their investment obligations including creating employment have revealed disappointing results."*[14]

—Hon Alexander Chikwanda- Minister of Finance-Zambia

Lack of Consistency in Supporting Policies

The emphasis on the issuance of tax incentives has not been coupled with the appropriate measures to ensure the sustainability of FDI inflows. According to the World Bank's Foreign Direct Investment Survey, a stable social and

12. Ee, e.g., Shah (ed.), Fiscal Incentives for Investment and Innovation, pp. 1-30 (1995); OECD, Taxation and Foreign Direct Investment: The Experience of the Economies in Transition (1995); and United Nations, The Determinants of Foreign Direct Investment: A Survey of the Evidence (1992)
13. "Zambia. Further Proposals for broadening Tax Base," IMF July 2013.
14. 2014 Budget Speech," Ministry Of Finance, October 2013

political environment is ranked 2nd in the determinants of FDI location while national taxes are ranked 11th.[15] A stable social and political environment entails policy consistency as well as a predictable economic framework; these enable investors to safeguard their investments. In the recent past there have been numerous policy inconsistencies with the introduction and reversal of key policies. The government recently introduced Statutory Instruments (SI) No. 55 of 2013 (empowering the Bank of Zambia to monitor inflows, outflows and international transactions) and Statutory Instrument (SI) No. 33 of 2012 (prohibiting the quoting, paying, demanding or receiving foreign currency as legal tender for goods, services or any other domestic transactions). Whilst beneficial in some aspects, these pieces of legislation adversely affected the operations of investors who incurred costs in complying with the new legislature. Both were later revoked after the public and stakeholder raised concerns. This is an indication of policy inconsistency resulting in reduced investor confidence.

Furthermore four separate government institutions oversee the administration of tax incentives. Although ZDA is the key player, the Ministry of Finance and National Planning, Ministry of Commerce, Trade and Industry, and ZRA all play critical roles. However this does pose a challenge in terms of coordination, as the two ministries are independent of each other, while ZDA and ZRA have very different objectives. Furthermore the Act grants discretionary powers to the Minister to issue incentives as well as amend schedules of the Act, which are discussed in detail later in the paper. This process proves a challenge as the incentive system lacks certainty and transparency, as it is dependent on individuals. For example an investor may successfully obtain an investment license from ZDA but must await permission from the Minister so as to activate those incentives through ZRA. A single legislature is needed to clearly define the roles of each of the institutions involved as well as a clear procedure to reduce the uncertainty and improve transparency in the issuance of tax incentives.

Independent Government institutions with opposing objectives

15. MIGA Foreign Direct Invest Survey, World Bank/Miga, January 2002.

Statement of the problem

1. Lack of one single piece of legislature that governs the issuance of incentives leading to a lack of consistency in the administration of incentives.
2. Lack of information on the cost of the incentives (loss in revenue collection).
3. Lack of monitoring and evaluation / public provision of data showing linkages between tax incentives and increased revenue

Legal Framework Governing the Provision of Tax Incentives

In Zambia there are three ways in which tax incentives can be enacted:

1. Policy formulation through the National Budget.
2. Through the powers vested in the Minister of Finance and the Minister of Commerce Trade and Industry in their respective acts.
3. Through Statutory Instruments signed by the Minister of Finance.

1. Policy formulation through the National Budget

Each year in October the Minister of Finance makes a presentation of the National Budget to Parliament containing fiscal policy direction for the on coming year. The Minister also makes pronouncements on policy direction in terms of government revenue and expenditure, including tax expenditures.

A tax incentive is subjected to a number of stages before it is adopted for policy formulation through the National Budget.

a) Submission of Tax Proposals

The first stage that an incentive goes through is the submission stage; this is a public call to all stakeholders and the general public by the Ministry of Finance and National Planning (MOFNP) to make budget submissions ahead of the National Budget Preparations. These proposals are collected and compiled by MoFNP and readied for the next stage.

b) Review of Submissions

The Tax Policy Review Committee (TPRC) set up by MoFNP is charged with the review of all tax related submissions. The committee constitutes representatives from the following institutions:

Institutions

1. **Zambia Development Agency;**
2. **Zambia Revenue Authority;**
3. **Ministry of Finance and National Planning;**
4. **Ministry of Commerce, Trade and Industry;**
5. **Ministry of Mines and Mineral Development;**
6. **Ministry of Tourism and Art**
7. **Ministry of Lands, Natural Resources and Environmental Protection**
8. **Ministry of Agriculture, Livestock and Fisheries.**

The TPRC submits a report outlining key recommendations to the MoFNP, and then a technical committee at Cabinet Office for review. Cabinet has power it accept, reject or amend the proposal and after review Cabinet prepare a Conveyance Report that is used as basis for policy formulation through the National Budget.[16]

2. Through the powers vested in the ZDA Act.

Part VIII of the Zambia Development Agency Act No.11 of 2006 gives powers to ZDA to administer incentives to investors. An investor must meet the ZDA criteria to be eligible to receive the financial incentives as prescribed by the act. An investor must have an Investment License or Certificate of Registration (CoR) issued under the ZDA act. The investor must meet the following qualification:

Qualifications

1. **Must have made minimum capital investment of $500,000 USD,**
2. **Must have invested in a priority sector or product and/or,**
3. **Must have invested in a priority sector or product within the Multi Facility Economic Zone (MFEZ).**

16. M.M Mukumbwa, UNZA 2012 "The Impact of Customs & Excise Remission Regulation (Tax Incentives) on Investment in Zambia."

Priority sectors are identified by the government as key to national development and are also used as a tool to redistribute investment across the country to ensure equitable development. Section 82 of the ZDA Act gives powers to the Minister to include or amend the schedule of the Act with regards to the priority sectors.[17] As of 2006, 12 sectors had been identified as priority sectors.[18]

General Priority Sectors

1. Flori culture: Fresh and dried flowers.
2. Horticulture: Fresh and dried vegetables.
3. Processed foods: Wheat flour and other processed foods.
4. Beverages and Stimulants: Tea and coffee products.
5. Production and the processing of cotton, fabric and garments in the textiles sector.
6. Manufacturing of copper, products, iron ore and steel, cobalt, and other engineered products.
7. Treatment of phosphates for fertilizer.
8. Treatment of rock materials for cement.
9. Production and processing of raw timber into wood products.
10. Production and processing of cattle hides, crust leather, leather products in the leather sector.
11. Building of mini-hydro power stations.
12. Education and skills training.

Priority Sectors and products have also been identified within the MFEZ. These include:

Priority Sectors within the MFEZ

1. Information and Communication Technology (ICT) .
2. Health.
3. Education and skills training.
4. Manufacturing.
5. Tourism .
6. Processing of agricultural, forest, non-ferrous metals, and gemstone products.
7. Real Estate development.

Once an investor has received the CoR and confirmation of the project being approved with special incentives, the investor is eligible for customs duty exemptions on capital equipment and machinery, and corporate tax incentives from first year of profitability.

In order to fully receive the tax benefits, the investor must apply through the ZDA Investments Office, who then recommend to the Minister's office at the Ministry of Finance. The Minister then approves the recommendation and the approval is sent to the ZRA for configuration into the system.[19]

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17. ZDA Act No. 11 of 2006
18. License Application Manual 2013, ZDA
19. License Application Manual 2013, ZDA

Figure 4. Tax Incentive Procedure

PROCEDURE

STEP 1

Investor must:

1. Invest a minimum capital investment of $500,000 USD

2. Invest in a priority sector or product and/or

3. Invest in a Multi Facility Economic Zone (MFEZ).

STEP 2

Zambia Development Agency (ZDA)

1. Issues Investment license to investors that have met the critera

2. Seek approval from Minister of Finance to effect tax incentives

STEP 3

Zambia Revenue Authority (ZRA)

1. Recieves directive from Minister of Finance to effect Tax incentive

2. Effects the Tax incentives

3. Through Statutory Instruments signed by the Minister

The ZDA Act under **sections 54, 55, 58 and 82** permits the Ministers of Finance and Commerce in consultation with ZDA to make amendments to particular sections of the Act. These particular clauses grant discretionary power to the ministers.

Zambia Development Agency Act No. 11 of 2006

Section 54: *The Minister responsible for finance shall in consultation with the Minister make regulations in respect of incentives offered under this Act.*

Section 55: *An incentive offered under this Part shall be valid for a period of five years from the grant of the licence, permit or certificate or for such period as the Minister responsible for finance may prescribe.*

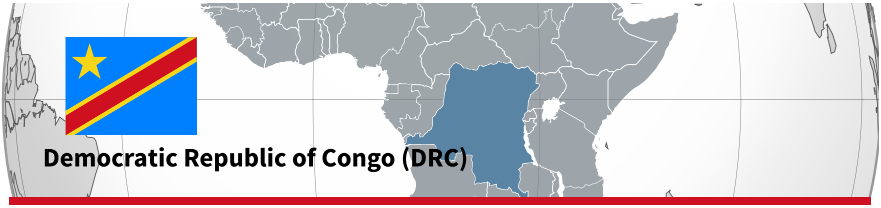
Section 58: *The Minister responsible for finance may, for the purposes of promoting major investment in an identified sector or product, by statutory instrument, and in consultation with the Minister, specify additional incentives for investment in an identified sector or product of not less than ten million United States Dollars or the equivalent in convertible currency, in new assets that qualify for those incentives.*

Section 82: *The Minister (Commerce, Trade and Industry) may, after consultation with the Agency, by statutory instrument, make regulations for the purposes of this Act.*

In 2006 the ZDA Act identified 12 priority sectors listed under the ZDA act. Through statutory instruments the number of priority sector has increased to 23. An example was the issuance of Statutory Instrument number 15 of 2011, which was an amendment to the Second Schedule paragraph (k); it was amended to extend power generation to include thermal, hydro and solar stations under the priority sectors.[20]

20. Statutory Instrument No. 15 of 2011 (ZDA (MFEZ)(Priority Sectors)(Declaration)).

Lessons leant



The Democratic Republic of Congo (DRC) like Zambia is a copper-producing nation. DRC has had similar trends in FDI inflows with DRC receiving US$2 Billion in 2013 compared to US$1.7 billion in Zambia in the same year. DRC had a significant change in its investment climate in 2004 with the following some of the highlights of the tax regime:

Figure 5. FDI inflows DRC vs. Zambia 2004-2013

Source: PMRC adaptation World Bank Country statistics

1. ELIGIBILITY

Investments eligible for incentives in terms of the Investment Code must represent a minimum of US$200,000, except Small and Medium Enterprises (SMEs) and Small and Medium Industries (SMIs) which qualify with investments between US$ 10,000 and US$ 200,000. However the Act does not specify if this must be capital or loan funds.[21]

2. TYPE OF INCENTIVES

Key tax incentives in DRC include:

- Lower taxes on dividends (mining) that are taxed at 10%,
- Lower taxes on profits taxed at 30% instead of 40%,
- Lower custom duty (2%) and import duty (5%),
- Exemption from business tax for a limited period for firms operating in priority sectors.[22]

3. PRIORITY SECTORS

This preferential regime allows exemptions in the following regions and will be granted for a limited period according to the economic area.

- 3 years for economic area A (city of Kinshasa)
- 4 years for economic area B (Bas-Congo, Lubumbashi, Likasi and Kolwesi)
- 5 years for economic area C (Bandundu, Equateur, Kasai-Occidental, Maniema, Nord-Kivu, Sud-Kivu, Province Orientale and Katanga).[23]

4. ADMINISTRATION

In order to benefit from the Investment Code, the developer is required to submit his investment project for approval by the National Investment Promotion Agency, also responsible for assessing implementation and compliance with investment requirements.

5. LESSONS

Currently in Zambia there is only one minimum capital requirement band (US$500,000). Very few local investors can meet this minimum capital requirement and thus the tax incentive system seems to favour foreign investor at the expense of locals. The introduction of multiple capital requirement bands would enable local investors to access incentives so as to meaningfully contribute to development.

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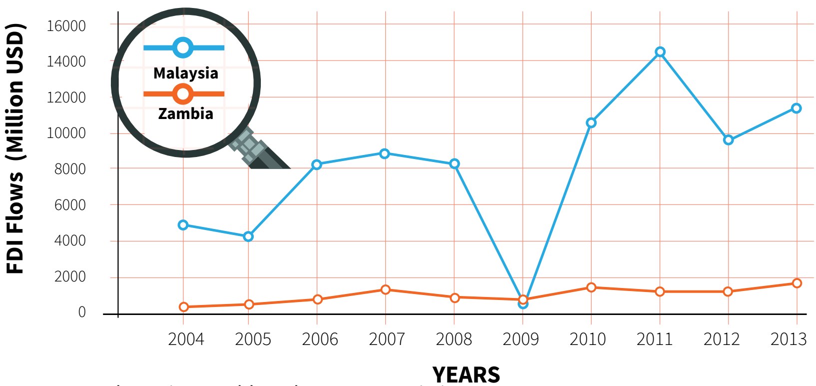
21. http://www.sadc.int/information-services/tax-database/dr-congo-investment-incentives/
22. ibid
23. Democratic Republic of Congo

Malaysia has set an ambitious target of becoming a developed country by 2020 and has adopted the stance of most developed countries of reducing emphasis on tax incentives. The Malaysian investment policy is aimed at making Malaysia an economic hub of the region and this is reflected in how the incentives are administered. Preferential treatment is given to investors that establish regional firms with their head quarters in Malaysia. Malaysia has performed well in attracting FDI, recovering from the 2008/9 world economic crisis when FDI flows dropped to US$ 114 million, which was less than Zambia during the same period (US$ 694 million). Malaysian FDI inflow then increased to US$10 billion in 2010, which is 10 times that of the previous year. The highlights of the investment regime are as follows:

Figure 6. FDI inflows Malaysia vs. Zambia 2004-2013



Source: PMRC adaptation World Bank Country statistics

1. ELIGIBILITY

Investors that operate in the manufacturing and services industry are eligible for tax incentives in Malaysia. The tax system also has a bias towards firms investing in high technology industries such as Biotechnology.[24]

24. PKF, Malaysia Tax Guide 2012.

2. TYPE OF INCENTIVES

Tax incentives available include; Pioneer status, special investment capital allowances, and a variety of tax deductions.[25] Malaysia has a deliberate policy towards making it a regional hub and as such the incentive system favors firms that engage in international operations with Malaysia at the centre. Special incentives are offered in three categories;

- RDC (Regional Distribution Centre)
- IPC (International Procurement Centre)
- OHQ (Operational Headquarters)

Firm that qualify under any of these 3 categories receive a 10-year tax exemption and 100% of income from direct export sales.

3. PRIORITY SECTORS

The Malaysian government has promulgated incentives for high-technology companies in the Multimedia Super Corridor (MSC), companies in the Economic Development corridors and small and medium-sized enterprises (SMEs). Other favoured activities include biotechnology, Islamic finance, venture capital, services, tourism, certain types of agriculture, petroleum, car component manufacturing, specialized machinery and equipment, energy conservation and environmental protection.[26]

4. ADMINISTRATION

Similar to the Zambian case, tax incentives in Malaysia are administered by the Malaysian Industrial Development Authority (MIDA), which works in collaboration with the Ministry responsible for finance.

5. LESSONS

There is need to introduce tax incentives that specifically reflect government's investment policy direction. A good example are the incentives that are aimed at promoting Malaysia as a regional hub as opposed to the use of general tax incentives.

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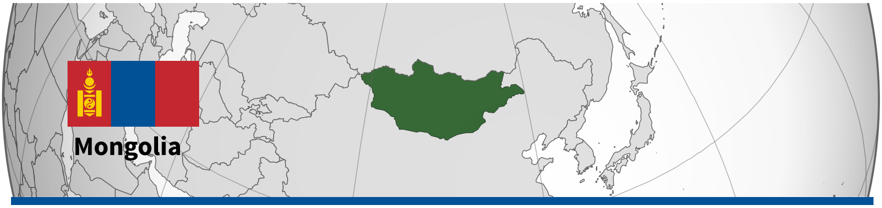
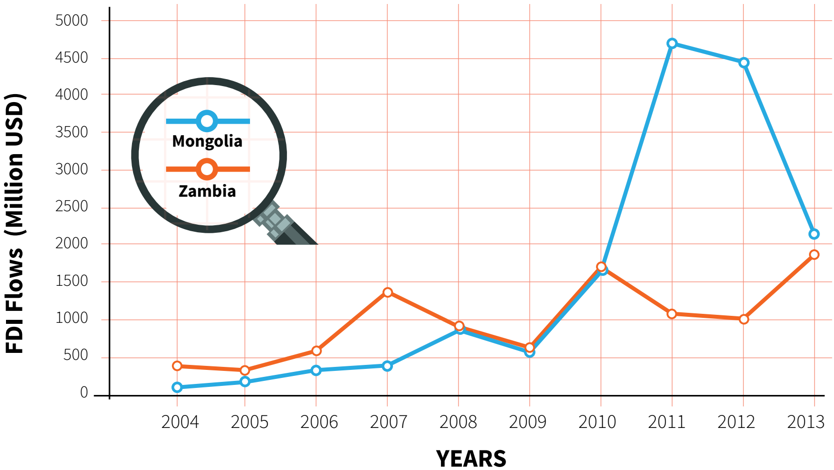
25. Deliotte, Malaysia International Tax and Business Guide, 2012.
26. ibid



Mongolia has a strong emphasis on mining as a driver of industrial production and has had similar trends in FDI inflows to Zambia over the last decade. In 2010 Mongolia and Zambia recorded similar FDI inflows of US$ 1.69 billion and US$ 1.73 billion respectively. However, the following years tell a different story with Zambia recording inflows of US$1.06 billion while Mongolia recorded US$ 4.45 billion. The growth can be attributed to change in the policy direction, which has seen a shift from the emphasis on the provision of tax incentives to ensuring and maintaining a stable economy and a very predictable taxation system.

Figure 5. FDI inflows Mongolia vs. Zambia 2004-2013



Source: PMRC adaptation World Bank Country statistics

1. ELIGIBILITY

Incentives in Mongolia are non discriminatory among local and foreign investors. Foreign investors are required to be registered as a Business Entity with Foreign Investment (BEFI) and are required to be incorporated in Mongolia with at least 25% equity held by an investor with a minimum contribution of US$ 100,000.

2. TYPE OF INCENTIVES

A limited number of tax incentives are available to entities that are engaged in the manufacturing and agricultural industries in Mongolia.

There has been a general move towards equality of treatment between national and foreign investors and a number of historical tax incentives that were available for foreign investment have been withdrawn in recent years.[27]

3. PRIORITY SECTORS

Priority Sectors include:

- Minerals,
- Heavy Industry,
- Infrastructure development.

Incentives are in the form of Stabilisation Certificates. These provide stable tax rates to investors over a stipulated period of time and vary depending on the type, amount and region of investment. The stabilisation period varies from 5 years to 18 years.[28]

4. ADMINISTRATION

The administration of incentives is managed by Invest Mongolia Agency, a government agency with similar functions to ZDA.

5. LESSONS

Mongolia's Stabilisation certificates aim to provide investors a guaranteed stable fiscal framework. The World Bank ranks a stable social and political environment second (2nd) in the determinants of FDI, highlighting the significance of this measure.[29] Mongolia has also moved away from dependency on tax incentives, highlighting the need to consider alternative strategies to attract investment.

27. KPMG Investment In Mongolia, 2012 Edition
28. Invest Mongolia Agency, Investment Guide to Mongolia 2014
29. "Zambia, Further Proposals for broadening Tax Base," IMF July 2013.

RECOMMENDATIONS

In view of the lessons learnt from international practice on the administration of tax incentives, PMRC makes the following recommendations:

1. COMPREHENSIVE ASSESSMENT ON COST-BENEFIT OF TAX INCENTIVES

The lack of information on the cost and benefits of tax incentives pose a challenge on decision making and policy formulation, thus there is need to undertake a comprehensive study on the costs and benefits of tax incentives. Future decisions regarding the introduction or reduction of tax incentives can therefore be based on empirical evidence.

2. STABILISATION OF THE INVESTMENT ENVIRONMENT

Shift emphasis from the provision of tax incentives to the provision of a stable investment environment. Policy inconsistency tends to be more harmful to investment and could out weigh the benefits that investors receive from incentives.

3. FORMULATION OF AN INVESTMENT POLICY

Formulation of an investment policy; this will clearly set out the direction of investment in the country. The policy should include the entire process of the administrative of tax incentives as well as clearly defining the roles of all institutions involved. The policy should also aim to remove discretionary powers enacted by the ZDA Act to all for the process to become more transparent.

4. REVISION OF EXISTING INCENTIVES

Revise current incentives; Learning for best practice, the design of the current incentives should be more specific to the Zambian scenario. These incentives propose a capital investment of $500,000, which is viewed as too high by local investors. This has led to the perception that the system is structured to favour foreign investors. The introduction of different brackets to disaggregate the capital investment amount would cater for local investors.

CONCLUSION

The country comparison highlights that the general administration of tax incentives in Zambia conforms to international practice. Incentives in other countries are administered by an investment promotion agency, as is the case in Zambia, this agency also works under close supervision of the government departments responsible for commerce or finance. The types of incentives offered in Zambia are similar to those offered world over and these include tax exemptions and preferential tax treatments.

However from the lessons learnt and the current situational analysis, it is clear that there is need to undertake a comprehensive study to ensure that the incentives offered promote economic growth and improve employment levels, and enhance FDI. Proliferation of the tax incentives through the current framework has led to an unnecessary erosion of the tax base, thus an extensive review of the current framework is required to halt this and ensure that the incentives are targeted only to the desired growth sectors. An assessment of the tax incentive framework should also encompass harmonisation of the administration of incentives so as to reduce discretionary powers of institutions with are more often linked to lack of transparency and uncertainty. The unrealistic requirement for qualification of the local investors for incentives has led to the general view that incentives are biased and skewed towards foreign investment. The qualifications for incentives need to be reviewed so as to accommodate local investors and stimulate local investment in priority development sectors.

Tax incentives have been successful in some countries and this has been dependent on the administration of these tax incentives. Comprehensive strategies and a clear policy direction would yield effective tax incentives that would contribute to the development of key sectors and the overall development of Zambia.

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