Policy Brief – November 2021

Tax Policies and Foreign Direct Investment in Tanzania

What is at stake

Without a proper structuring of tax policies to address existing gaps, achieving four important goals poverty reduction, sustainable growth and development, integration in regional and global trade, and women and youth empowerment will be seriously hindered.

What is the ambition

This Policy Brief presents key findings and recommendations of a study on whether and how tax policy effect investment decisions by foreign investors, and specific policy gaps that may have a significant influence on the flow of Foreign Direct Investment (FDI) into Tanzania. The study is based on analysis of previous studies as well as primary data from a survey of key FDI stakeholders conducted from June to September 2021. Based on the findings, proposals for improving the fiscal policy design, including impact analysis on policy decisions that may affect FDI are presented. The aim is to provide a framework for developing a successful longer-term tax policy, where trade-offs must be done in order to maintain economic growth and stability.

Background

For over three decades, FDI has been one of the most discussed topics in the drive for economic growth in Tanzania. In general, FDI is used by nations as a strategy to help transform their economies and accelerate growth and development. FDI also positively affect a host country's balance of payments through an increased inward flow of foreign capital. However, such beneficial effects do not manifest themselves automatically and should not be taken for granted. For a developing country like Tanzania, to maximize the benefits of FDI the government must employ a range of macroeconomic policies and measures. The effectiveness of these policies is seriously being questioned, especially considering the level of instability in the policy environment over the past five years.

FDI in Tanzania, some figures

Tanzania's increased its ability to attract foreign capital is reflected in the rapid growth of FDI whereby Tanzania received a billion dollars of investment inflows between 2000 and 2005 compared to a mere $70 million from 1990s to 2000s period [1]. This increase placed Tanzania in the higher ranks of African economies in terms of FDI and at the very top of the list in terms of non-oil countries. However, FDI inflows in Tanzania dropped from USD 1.5 billion when to just USD 846 million in 2015, and only slowly recovering year by year to reach only USD 1.1 billion in 2020[2]. As a result, the government met only 10% of the targeted FDI by 2020. In recent years, tax policy has often been cited as a major factor for the decline of FDI in Tanzania.

[1] Tanzania Investment Report, 2018
[2] World Bank Report, 2020

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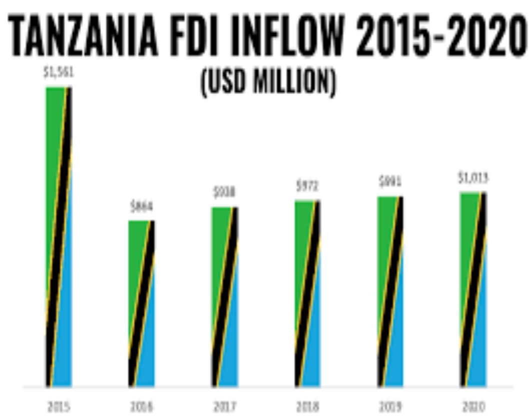
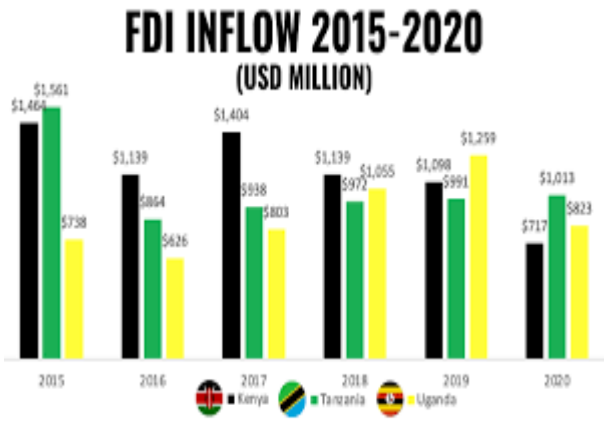
Taxation and FDI, an unsettled debate

The actual effect of government policy on FDI has attracted increasing attention from economists and policy makers in Tanzania. Tax policy has been used as a major tool to attract capital flows (i.e. tax rates, tax incentives, tax holidays, withholding tax and tax concessions). A lot of controversy exists on whether tax policy is actually all that effective in attracting FDI in Tanzania.





Source: Tanzania Invest, 2021

Some key findings

The study analyzed the role and impact of tax policy in attracting and sustaining the level of FDI in Tanzania. Findings conclude that tax incentives could have a significant impact on FDI both in short term and long term. There have been persistent problems with the implementation and enforcement of tax policies, and with the interpretation of decisions that are taken at central level. As a consequence measures fail to be enforced uniformly further down the line. Therefore lowering/reducing taxes is an economic policy instrument that can attract more FDI in Tanzania. For tax policy to be effective in attracting FDI however, and to bring in spillover effects, the government should focus most of all on reducing production costs, improving the business environment, and on ensuring political and macroeconomic stability. These are the most important factors affecting FDI decisions to Tanzania. Moreover, it was found that, when comparing the range of economic sectors most likely to receive FDI, agriculture, mining and real estate appear to be the most sensitive to (changes or instability in) tax policies. Therefore, reducing the amount and/or number of taxes is a policy instrument that can attract more FDI in Tanzania, with stability in policy as a key element in FDI decision making. For a more detailed overview of findings and recommendations, please refer to the table on page 3.

Exempting foreign investors from domestic tax avoids a possible tax impediment for these firms when competing in foreign markets with other investors who have tax incentives advantages in their respective host countries.

Key recommendations

- Conduct a complete overhaul of the country's tax system to promote a more favorable investment climate with a reliable tax stability so as to improve competitiveness.
- Expand the scope of tax incentives to include priority and emerging sectors, including ICT and the blue economy, and to pay more attention to FDI by small and medium level investors (SMEs).
- Expand the range and role of non-tax incentives including financial incentives.

Policy Recommendations

Existing Gap	Policy Recommendation(s)	Expected Outcome/Impact
There have been frequent changes of tax policy in Tanzania especially in the past five years. Investors look for certainty, predictability, consistency and timeliness in the application of tax rules, and in many cases these considerations are as important as the effective tax rate paid.	The government must conduct a completely overhaul of the country's tax system. In doing so, a Cost-Benefit analysis should to be carried out in order find a balance between the interests of both the government and investors.	To promote tax stability and improve Tanzania's tax competitiveness.
Inadequate domestic revenue collection haunts the Tanzania's tax system. This challenge hinders provision of adequate tax incentives to boost the economy. The average tax to GDP ratio in Tanzania is only 14 percent, which is much lower than the estimated level of 25 required for financing development needs.	Design appropriate polices to improve on Domestic Revenue Mobilization based in the country's revenue capacity.	Broadening tax base and strengthen tax collection capacities to finance development needs .
Limited scope of incentives in the absence of specialized tax incentives as in other countries in the automotive manufacturing industry; areas with logistical challenges ; expansion projects and priority sectors including ICT, Small Investors (SMEs) and the blue economy.	Create a more powerful Commission in place of TIC under the Prime Minister Office with the mandate to give incentives as they see fit. Broaden the criteria to be covered by the incentives of this new Commission i.e. education, aviation, investing in low-income regions, healthcare, etc. Allow Tax incentives for existing investors, when they re-invest or start new investment within the current investment. Centralize tax collection to one main platform.	Expanding the scope of incentives will stimulate both local and foreign investment in different sectors.
Limited focus of non-tax incentives	Design appropriate financial incentives for foreign investors. The Immigration Department may put in place a mechanism to attract investors who contribute significantly to the economy to remain in the country and invest more by granting residency permits for the period.	Expand the scope of non-tax incentives to boost more FDI.
Failure to implement the Special Economic Zones (SEZ) plan due to contravention of the East African Community Customs Tariff Act.	The Ministry of Finance and Planning to prepare and submit proposals for amendments to the East African Customs Act.	This will facilitate the implementation of the SEZ law on tax incentives.
The Investment Act of 1997 further protects a special investor by specifying that the tax incentives imposed on the investor will not change or be adjusted in a manner that will affect the investor for a period of five years.	It is recommended that this point be included in the Monetary Policy.	This will help the government to make adjustments in line with the country's economic needs at the time and will also prevent investors from using it to sue the government and causing it losses.
The National Investment Steering Committee's (NISC) authority to approve additional tax incentives that are being proposed by the Minister responsible for investment has been ineffective as they are outside the scope of the Tax Laws in the country. There are more than 19 projects that have failed to find additional special attractions approved by NISC.	Define NISC's role as approving the proposed additional tax incentives for BLM instead of the current role of approving the attractions. Establish a condition that will enable the Financial Laws to implement BLW decisions regarding the provision of additional tax incentives;	More improvement of investment climate.
The current tax incentives do not consider importance of other taxes such as payroll taxes and non-profit-related business taxes which are increasingly under the spotlight by investors and policy makers.	Increase the scope of tax incentives to consider payroll taxes and non-profit-related business taxes.	
Despite significant efforts that the government and other stakeholders have done to improve business environment, the rate of business environment is still low. Efforts include preparation of the Blue Print for Business environment and a successful execution of BEST-Dialogue project.	Increase the rate of Blue Print implementation. Revisit the recommendation made in the Blue Print to revise them based on the current investment climate.	Improve business environment.
Costs of business initiation and operations can be high, as they include investment related to infrastructure, export ability, labour issues, and tariffs. Some of these costs/fees are hidden fees that investors only find out about upon arrival and during production rather than prior to commencement of project.	Increase dialogue and engagement with the private sector to understand inception barriers. Provide clear guidelines on fee structures. Ensure accountability for regulations.	Increased engagement with the private sector will allow the authorities to reduces issues of conflict related to business inception in Tanzania. Providing clarity and transparency about fees prevents investors' impression of being harassed by regulatory authorities, increasing their trust. Increasing the effective accountability for regulators will minimize abuse of the power to impose premium payments, penalties and fees.

Some concrete examples of what may influence FDI decision making

- Taxes and tariffs in the fishing industry in Tanzania are five times higher than those charged in Uganda. As a result, many foreign fishery investors prefer Uganda. Moreover, despite the fact that more than 50% of Lake Victoria is found in Tanzania, Uganda has a larger fishing industry than Tanzania.
- The tax burden for the horticulture subsector in Tanzania is 30% higher than in Uganda and two times higher than in Zambia.
- A horticulture exporter is required to pay a radiation fee of 0.2 percent of the invoiced value. But this certificate is not needed or recognized in the international market and not charged by other competing countries.

There are also other crucial points, not directly tax related, that have an influence, such as:

- For a foreign investor the initial cost to start a business in Tanzania is USD 1,000 while in Rwanda it takes only USD 265 to establish a business.
- Moreover, it takes three months for a foreign investor to start a business in Tanzania while in Rwanda it takes only 2 days to establish a business.
- The cost of water for the textile industry in Tanzania is USD 0.89/m^3. In Kenya the cost is USD 0.62/m^3 and in Ethiopia USD 0.12/m^3.
- The cost of electricity in the textile industry in Tanzania is USD 0.10/kWh. In Ethiopia that is USD 0.02-0.04/kWh.

About the author
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