Tax incentives for Investment with a Special Reference to Egypt Introduction Tax legislation is tax law issued by the legislative authority (people's council) according to the institutional rule: the right of establishing, adjusting and canceling taxes is a pure right for the legislative council of the community.In Japan, tax holiday is granted mainly to new businesses that are directed toward exporting and petrochemical industries and toward "targeted industries" that are related to developing technology and environmental protection and achieve social equity, however, in times of extended budget deficit this tax incentive becomes less important. In Morocco, new investments in tourism sector are granted tax holiday for five years, and then this grace period is extended to a subsequent period of taxation at a reduced rate (50% of the formal tax rate). Almost all countries grant tax exemption for savings, this permanent tax holiday is important since investments depend partially on quantities of savings for financing investments. In Spain, this incentive is called Tax Preferred Pension Fund. In England, payment for servicing debt related to buying houses as well as pension and capital gains are exempted from personal income tax and this is called Special Saving Accounts Tax Exemption. In the US, retained profits as well as, pensions, life insurance and installments for buying houses are exempted from personal income tax. In Italy, returns to bank deposits, post office deposits, personal bonds, and capital gains are exempted from the personal income tax. In Germany, savings are exempted. Tax holiday is extended to the greatest scope in Bahamas where there are no taxes on capital gains, corporation income, personal incomes, sales as well as returns to shares for individual, personal firms, and for corporations. Tax holiday is also used in commercial preferential trade agreements among countries, in these agreements countries agreed to grant mutual custom's exemptions for tradable goods that fulfill the origin criteria, usually a good that has a local components equivalent to 40% of the value added of the final product will satisfy the national origin criteria. Tax Holiday in Egypt According to tax law 91 for year 2005 two kinds of investments are temporally exempted form income tax as following: 1- Profits of land reclamation or cultivation enterprises, for ten years from the date of activity inception. 2- Poultry farming, apiculture, livestock husbandry and fattening, fisheries, fish farming enterprises and fishing boats enterprises profits, for a period of ten years from the date of activity inception. On the other hand permanent exemptions from income tax according to law 91 for year 2005 includes: 1- Physical persons' income received from their investment in securities registered with the Egyptian Stock Exchange Market. 2- Physical persons proceeds from: a) Securities and financial deeds of different types, registered with the Egyptian Stock Exchange Market, whether issued by the State or shareholding companies. b) Dividends from shares in joint stock companies and partnerships limited by shares. c) Dividends from equity quotas in limited liability companies, partnerships, and partnerships limited by shares. d) Dividends from investment securities issued by investment funds. 3- Interest which physical persons receive from their deposits and saving accounts in banks registered in the Arab Republic of Egypt; investment, saving and deposit certificates issued by said banks; deposits and saving accounts in post office funds and securities and deposit certificates issued by the Central Bank. 4- Profits from new projects set up by funding from the Social Fund for Development (SFD) to the extent of such funding for a period of five years from the date of starting the activity or starting production, as applicable. This exemption will only apply to those whose names were signed in the loans of the Fund. 5- Educational institutions, subject to the supervision of the government, public legal persons, Public Sector or State-Owned Enterprises (SOE). 1- Revenues of self-employed professionals registered as members of their professional syndicates in their fields of specialization, but only for three years from the date of practice. 2- Revenues of areas planted in desert lands for a period of ten years starting from the date the land is considered productive Low Tax Rates Regimes applying reduced tax rates to certain activities or enterprises require a number of rules to minimize tax avoidance. A typical example can be given of low tax rates applied to income earned by small businesses. The first problem is to define small businesses in relation to a given threshold. The threshold can be measured in terms of assets, capital, number of employees, or total sales. The choice among these criteria, which can be used in combination, will depend in part on the type of business being targeted and on the compliance and administrative costs that are entailed. Care must be taken to target the low tax rate to appropriate types of activity and to prevent it from being used to avoid taxes that should be paid at the personal level. Tax legislator reduces the tax rate for the targeted industries relative to other industries. Targeted industries are more important and vital for the society, e.g. industries encourage technological developments, or manufacturing or that preserves the quality of environment, or industries that exporting their output to foreign countries. In Lebanon, corporations are liable to lower tax rate than individual and personal firms who make net profits greater than specific amount. In number of countries tax legislator relates the rate of reduction in income tax to the turnover number of the firm, or to the new products produced by the firm. This tax incentive may be granted to corporations that have tradable securities in the stock market. This means that tax incentives may be used to change the legal form of the firm, and to make these firms more open, which may encourage family business or closed ones to be changed into joint stock firms. Countries may provide reduced rates of, corporate income or profits tax to particular types of activity. Some countries provide a reduced rate of tax for certain types of investment (e.g., the reduced rate for manufacturing in Ireland). Other countries provide reduced tax rates for investment in particular locations or regions (e.g., the reduced rate for investment in special economic zones and other designated regions of China). The Egyptian legislation: a) Used preferential tax treatment in tax law 187 for 1993, where corporation income tax was reduced from 40% to 32% for industrial business and for income generated from export. This tax incentive was canceled in the tax law number 91 for 2005. b) Exempt profits from the revaluation of the assets of a sole proprietorship will be exempted from income tax when providing this as an in-kind share to the capital of a joint stock company, providing that the shares corresponding to the in-kind share are nominal, and shall not be disposed of within five years c) Deduct 30% of the cost of the machinery and equipment used in production, whether they are new or used, at the beginning of each tax period during which such assets are used. The depreciation base shall be calculated for that period after the deduction of the said 30% amount. The taxpayer must maintain proper books and accounts. Accelerated depreciation of capital assets The term "accelerated depreciation" generally refers to any depreciation scheme that provides for writing off the cost of an asset, for tax purposes, at a rate faster than the true economic depreciation.Other tax incentives: Zones Countries use two types of special "zones" to attract investment: (a) duty-free zones, enjoying exemption from customs duties (and usually from VAT); and (b) special economic zones, in which investors enjoy other tax privileges not granted in other parts of the host country. Duty-free zones and export processing zones (EPZs) are intended to facilitate the trans-shipment of goods, and the processing of imported materials or components for export. Exemption from VAT and customs duty is granted on imported goods, because those taxes would normally be refunded on export. To grant additional tax privileges (e.g., tax holidays) to these activities may be inappropriate and may violate the WTO prohibition against export subsidies. By contrast, special economic zones are intended to promote economic activity within a designated area, and are not restricted to exporting. They consequently should not be given favorable customs treatment. Double taxation prevention treaties Signing these kinds of treaties will reduces tax burden for foreign investors and will encourage them to invest more in the country. It is important for tax legislator to be sure that this tax incentive is being directed towards investors and not their countries. This task is not simple. Egypt Has signed 30 double tax prevention agreements with different countries, these countries includes: Italy, Yugoslavia, Denmark, Libya, Germany, Syria, Korea, Hungary, Cyprus, United Arab of Emirates, Cheek Republic, Sweden, Jordan, Belgium, Lebanon, Turkey, Tunisia, Pakistan, South Africa, Bella Russia, The Arab Union Countries, Bahrain, Palestinian Liberalization Organization, Bulgaria, The Netherlands, Yemen, Malta, Poland and Ukraine. Indexation Advanced countries use indexation to cancel the effect of inflation on the tax burden of individuals and corporations, through relate tax bases and some kind of price indices. This method prevents what is called "Brackets Creep" which implies increasing tax burden without a real increase in the real income; this will preserve the real levels of profits and income. In addition one of the important GATT's agreements was "Commercial aspects for the investment regulations" which requires from any country sign the agreement not to discriminate against foreign investment "National treatment principle", so any country should eliminate all investment regulations break this principle. Tax and non-tax incentives Some general notes should be considered when discussing tax incentives for investment, these are as following: 1- The existence of tax incentives is a necessary condition for attracting local and foreign investments, but it is not a sufficient one. This can be explained by the need for the existence of important additional conditions (non-tax incentives for foreign investments) such as: a) Political stability and security inside the country, since capital cannot be attracted to places that lack security and stability. b) Sufficient legal guarantees for investors against confiscating of their capital, the right to transfer their money abroad, the right to liquidate their business and to choose a court system different from local system, and may be the existence of institution to guarantee investments. c) The perception of local people toward foreign investment, for example if they perceive foreign investments as necessary for development and for creating work opportunities for local people, and the social environment is open, then this will encourage these kinds of investments. d) The existence of a good infrastructure and good investment opportunities, this is because foreign investments are attracted to less developed countries not to develop these countries but to participate in the development process of these countries and to take advantage over this participation. e) The existence of stock markets especially to develop indirect investments in order to expand existing capacities and to develop the already established business. f) Joining WTO as an important signal for openness of country's markets of goods and services and that there is no control over foreign exchange. 2- Excessive generosity in providing tax incentives to encourage investors may not work; in fact these excessive incentives may increase economic problems of the national economy; creating or increasing budget deficit because of the decrease in tax revenues due to the incentives. Budget deficit's problem may be very difficult for economies suffering from expanding public debt, in this case a country will find itself forced to finance budget deficit through either borrowing more money from the banking system which creates inflationary pressures or through imposing more taxes and this will affect economic sectors negatively and will reduce the efficiency of tax incentives themselves.. 3- Countries attracting foreign investments should be interested not only in the quantity of investments but also by the quality of them. It is noticed that most of foreign investments attracted to the Arab world are from the traditional industries and not from the high technology industries like the case for Asian and Latin American countries. High technological investments increase the competitive position of these countries in the future. One reason for the lack of high tec. Industries in the Arab world is the ineffective protection for property rights. 4- The severe competition among less developed countries in attracting foreign investments, especially in this era of WTO, may increase the cost of foreign direct investment to LDC's in terms of increasing public expenditure on infrastructure and other facilities and a reduction in government revenues because of tax incentives. One of important conferences addressed this issue "Investment's horizons and guarantees" was held in Beirut in 2002 has reached that the major reasons for low level of foreign investments attracted to the Arab countries were: a) Bureaucracy and value judgment of the administrative authorities in these countries.For those countries, however, that do not generally provide accelerated depreciation, a tax incentive can provide for deducting the cost of acquisition more quickly than would be allowed under the normal "benchmark" depreciation schedules. The cost of accelerated depreciation, in terms of tax revenue foregone, is normally less than that of tax holidays or investment allowances/credits, since it is only the timing of the tax payable, and not the amount of tax, that is affected. That, of course, can still be a substantial benefit to established businesses that are planning to increase their investment, but in the case of most initial investments, where there may be no profit for several years, accelerated depreciation will be of no benefit. To understand how this tax incentive works let us analyze the following exercise: the acquisition, cost of a productive asset is one million pounds the expected economic life of this asset is ten years, net annual profits for this asset is 200,000 pounds, the nominal tax rate is 15%, if the discount rate is 10% and the salvage value for the asset is zero at the end of the asset life. Calculate the increase in the net present value and the internal rate of return when applying the accelerated method (five years) instead of the normal depreciation method. First: normal depreciation method: Annual depreciation installment = 10% or L.E. 100,000 Net present value of the asset = L.E 136,700 Internal rate of return =13% Second: Accelerated depreciation method: Annual depreciation installment = 20% or L.E.200,000 during the first five years, then it becomes equal to zero during the last five years of the asset life. Net present value of the asset = 13.8% Now by comparing between the two methods we found that accelerated depreciation has increased the net present value by L.E 21,900 or 15.79%, at the same time internal rate of return has increased by 6.15% in the case of accelerated depreciation. This tax incentive has been used by many countries, In US, during the Korean War; accelerated depreciation was used in industries that support the war. In particular, businessmen are required to have a certificate from the department of defense that their product is important for defense purposes to have the right to use the method of accelerated depreciation. By the end of the war, US government stopped using this method of depreciation for defense purposes. In Canada tax legislator use this method in the manufacturing, capital, agriculture industries, and mining, where a special accelerated depreciation scheme of two years is used, they call this method "Accelerated Capital cost Allowances".In fact investment in tools, equipments, machineries and productive capacities (formation of human capital through good education and health programs and in natural capital through increasing the absorptive capacity of the environment) achieves economic growth through two avenues; direct method (increasing the capabilities of the national economy by building infrastructure: electric power, water, roads, airports and communication systems that encourage businessmen to invest in manufacture industry. This investment will create new jobs and opportunities for exports and increase gross national product and improving the standards of living. Readers should remember that the final increase in the income and production will be a multiple of the initial increase in investment because of the existence of investment multiplier and investment accelerator. b) Encouraging domestic industries to supply foreign investment with equipments, materials and services, since FDI usually increases the demand on local components of these investments.There is another indirect avenue in which investment encourage economic growth, which can be explained through: a) External economies achieved to the national economy through transferring technology and other administrative and marketing skills that foreign direct investment (FDI) brings to the domestic industry, in addition, through demonstration effect by the domestic industry to the foreign industries located locally.Accelerated depreciation method in Egypt: This method has never been used for depreciation of assets; however income tax law 91 for 2005 has, to some extent and implicitly, used this method by stating specific tax life time for different assets as following: 1- 5% of the cost of procuring, constructing, developing, renovating or reconstructing any building, establishment, ships and aircrafts, for each tax period.Non-tax factors are the market size, access to raw materials, e.g., natural resources, energy supplies, availability and cost of skilled labor, access to infrastructure, transportation costs, access to output markets, e.g., high consumer demand in region, low export costs, political stability, macro-economic stability and financing costs. The mobility of economic resources among countries helps solving two economic problems: domestic resource gap (when a country needs a level of investment greater than domestic savings), and foreign exchange gap (when the value of imports exceeds the value of exports evaluated by the foreign exchange).b) During this stage, governments may establish free zone areas to encourage investments located in specific locations or regions like ports, airports and regions where good investment opportunities are existed for production and exports.This grace period is might be extended for the whole productive life of firms, and sometimes is extended to a subsequent period of taxation at a reduced rate Tax holidays have the apparent advantage of simplicity for both the enterprise and the tax authorities; however a number of technical issues are important in determining the impact of tax holidays on the return on investments.How useful, and at what cost, depend on how well the tax incentives program is designed, implemented, and monitored It should be noted that accelerated depreciation and tax credits are more efficient than tax holiday, since they enter directly into the feasibility studies of the projects, and are related to the size of investment and profits.The following appendix shows tax incentives in three emerging economies in south-east Asia: Indonesia, Malaysia and Philippine, it may be a good exercise for students to compare between the tax incentives in these countries and in Egypt, and relate these incentives to the size of FDI in these countries in order to get some useful conclusions.The incentives are used for direct investors to real investment in productive activities rather than investment in financial assets, and are often directed to foreign investors on the grounds that there is insufficient domestic capital for the desired level of economic development and that international investment brings with it modern technology and management techniques.In the post-WTO world, developed countries also adopt tax regimes that favor export activities and seek to afford their resident corporations a competitive advantage in the global marketplace.Almost all countries have issued investment laws that concern with encouraging investment; provide different kinds of guarantees to investors in areas of free trade, transferring profits abroad, freedom of movement of labor, raw materials, and capital among countries.Not only free trade areas are existed inside countries but also regional and international free trade areas are established among different groups of countries e.g. Greater Arab Free trade Area GAFTA which will encourage intra-trade among Arab countries and encourage FDI in the region if the Arab countries have a strong political will to make it successful.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.Now if Tax incentives are successful in encouraging more investors, then tax revenues will automatically be increased as a result of the increase in the gross domestic product and this will compensate the decrease of tax revenues because of the provided tax incentives. From the empirical point of view: There exist different kinds of case studies that proof the great importance of investments to national economies as following: a) International comparison among countries shows that there is a positive and significant relationship between growth rate in GDP and the investment/output ratio.These two gaps are highly correlated; in addition foreign exchange gap may not be covered by rising saving rate of the community if the domestic investment requires equipments and raw materials import spare from abroad.Tax incentives in the developing countries are used to encourage domestic industries and to attract foreign investment.