Analysis of the Tunisian Tax Incentives Regime

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"…We are working with Tunisia, who joined the Convention on Mutual Administrative Assistance in Tax Matters in July 2012, to review its tax incentives regime and to support its efforts to develop a new investment law."

Remarks by Angel Gurría, OECD Secretary-General, delivered at the Deauville Partnership Meeting of the Finance Ministers in Tokyo, 12 October 2012

1. Executive Summary

This analysis of the Tunisian tax incentives regime was conducted by the OECD Tax and Development Programme[1] at the request of the Tunisian Ministry of Finance. Following discussions with the government, the OECD agreed to conduct a review of the Tunisian tax incentive system within the framework of the *Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries.*[2] As requested by the Tunisian authorities, the objective of this review was to understand the current system's bottlenecks and to propose changes to improve efficiency of the system in terms of its ability to mobilise revenue on the one hand and to attract the right kind of investment on the other. The key findings are based on five days of intensive consultations and analysis.

Key Findings and Recommendations

A comprehensive tax reform effort, including tax policy and tax administration, is critical in the near term to mobilize domestic resources more effectively. The tax reform programme should include, but not be limited to, the development of a new Investment Incentives Code, aimed at transforming the incentives scheme.

- In order to streamline tax incentives, restore a level playing field for all investors and improve the investment climate so it is more favourable to high value-added up-market investment which creates permanent high-skilled jobs and breaks down the isolation of disadvantaged regions, the following recommendations could be taken into account:
    - Reduce the dichotomy between the offshore and onshore regimes – the two largely unintegrated segments of the Tunisian economy. If politically feasible, a clean tax system with few preferences of any kind, a broad tax base and moderate tax rates (of around 15%) is much preferred to any alternative

[1] For additional information on the OECD's Tax and Development Programme see: *www.oecd.org/ctp/globalrelationsintaxation/taxanddevelopment.htm*.

[2] *www.oecd.org/ctp/globalrelationsintaxation/Principles_international_engagement_Revenue_Matters.pdf*.

structure on both administrative and policy grounds. As a second-best option: (*i)* the tax holidays regime for the offshore regime should be abandoned as it attracts footloose investment with a short-term horizon and significantly erodes government revenues; and (*ii)* a uniform lower tax rate for the onshore regime should be considered.

    - The current provisions that allow for tax relief of reinvested earnings and profits granted solely on the basis of a declaration of investment intent, is easily a subject of abuse by Tunisian taxpayers, and should be revised.
    - General incentives in the form of well-designed investment tax credits or accelerated depreciation could be applied as they encourage longer term investments and incur less revenue loss to the government.
    - The undue complexity that currently burdens the legislative and regulatory framework should be addressed as soon as possible. A long list of largely unused tax incentives could be considerably curtailed. General simplification and improved transparency of the legislative framework would go a long way in enabling a dynamic business environment.

- A well-staffed Fiscal Analysis Unit (FAU) should be established at the highest level, preferably within the Ministry of Finance. One of its principal responsibilities should be monitoring tax policy and the special provisions that deviate from standard tax treatments to determine their revenue consequences and likely economic/investment effects.
- An inter-agency data exchange system should be built to break current "information silos" and serve policy analysts in economic and tax analyses and modeling. An important exercise of indexing, classifying and linking information and databases together, including the development of a common data identifier, must be addressed as soon as possible.
- Various investment agencies and their associated networks could be consolidated as they create unintended waste and overlap. Consolidation of the numerous agencies currently present on the Tunisian investment scene will also help avoid the inconsistent application of investment incentive measures, which is inevitable under the current arrangement.

2. Introduction

This analysis of the Tunisian tax incentives regime was conducted by the OECD Tax and Development Programme at the request of the Ministry of Finance, in close co-ordination with the Tunisian authorities. Following discussions with the Tunisian government, the OECD agreed to conduct a review of the Tunisian tax incentive system within the framework of the *Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries*. These principles, developed by the OECD Tax Force on Tax and Development, are emerging as an international consensus on transparent and consistent management and administration of tax incentives globally. Although the principles have been developed as a voluntary code (a framework), their use by all countries is encouraged.

As requested by the Tunisian authorities, the objective of this review was to understand the current system's bottlenecks and to propose changes to improve efficiency of the system in terms of its ability to mobilise revenue on the one hand and attract the right kind of investment on the other. The timeliness of this study can not be overemphasised, as post-revolution Tunisia has embarked upon a new and ambitious development model that is inclusive, fair and equitable and based on the principles of good governance, transparency and citizen participation. One of the immediate objectives of the Tunisian authorities is to design and implement a new Investment Code. This study intends to feed into the development of the new Investment Code and support the efforts of the new Tunisian government in designing a more effective and transparent framework for tax incentives for investment. This report is based on a single five-day Mission to Tunisia. Further analysis of the investment incentives should be undertaken in a broader context of s comprehensive tax reform.

The rest of this report is organised as follows. Section 3 provides an overview of the current political and socio-economic situation in Tunisia to set the stage for further discussion. Section 4 analyses the tax incentives regime against the Principles of transparency and governance. Section 5 sets out the concluding remarks. Annex A presents an overview of the fiscal and financial incentives in Tunisia and Annex B serves as an illustrative example of the Marginal Effective Tax Rates (METRs) calculation.

3. Background

Following the overthrow of President Ben Ali, Tunisia has embarked upon a new development model based on the principles of good governance, transparency and citizen participation. A new coalition government, led by once-banned Ennahda, emerged in October 2011 after democratic elections for the Constituent Assembly.[3] This new interim government faced high economic and social expectations on the one hand, and a deteriorating socio-economic situation on the other. It had inherited a host of challenges:

[3] New general elections are expected to take place in March 2013; the Constituent Assembly will exercise legislative power until then.

- a state-centered development model compounded by corruption and nepotism, with economic gains owned by a privileged few, fueling a sense of denied opportunities among the rest of the populace;
- high unemployment (13% in 2010), especially among the youth (about 30% in 2010);[4]
- pronounced economic and social disparities across various regions in Tunisia with poverty rates ten times higher in the most disadvantaged Centre-West region as compared to the Centre-East region;[5]
- the dichotomy between the favoured, heavily incentivised offshore regime and the tightly controlled onshore sector, with little spillover between the two;
- investment incentives that favour low value-added industries, intensive in unskilled labour, effectively turning the country into an "assembly plant";
- an offshore regime that has done little in terms of technology transfer or employment of high-skilled labour.

These challenges have been further complicated by the current political uncertainties and social tensions that fuel the wait-and-see attitude of both foreign and domestic investors. A weak economic situation in Europe, Tunisia's main trade partner, puts further downward pressure on the current account and Tunisia's economic prospects.

These challenges notwithstanding, Tunisia is entering into its closely-watched reform stage with a lot of optimism and some room to maneuver. The country's macroeconomic framework is healthy, with one of the highest *per capita* GDPs in Africa, almost USD 9 500 on a purchasing power parity basis in 2011.[6] Tunisia boosted a healthy 5% GDP growth rate between 1999 and 2009, with inflation averaging around 3% a year. The budget deficit remained below 3% of GDP between 1991 and 2010, and the debt stock stood at about 40% of GDP in 2010. Although foreign reserves declined in 2011, Tunisia is not yet looking to borrow; and it can count on the support of multilateral and bilateral donors.

Although some emergency measures have been undertaken by the transitional government to promote employment and regional development, longer term, carefully thought-through reforms must be pursued to strengthen the confidence of domestic and economic agents and give hope to Tunisia's unemployed youth. One of the key initiatives undertaken by the Tunisian authorities is the development of a new Investment Incentives Code, aimed at transforming the incentives scheme in such a manner that it is more favourable to high value-added up-market investment that creates permanent high-skilled jobs and breaks down the isolation of disadvantaged regions.

[4] Source: National Institute of Statistics.

[5] The poverty rate in the Centre-West region is equal to 12.8% versus 1.2% in the Centre-East region (National Institute of Statistics).

[6] Source: IMF (2012), Staff Report for the 2012 Article IV Consultation .

4. Review of the Tax Incentives Regime Against the Principles to Enhance Transparency and Governance

This section compares the tax incentives regime in Tunisia against the OECD's *Principles to Enhance the Transparency and Governance of Tax Incentives*. Our goal is to identify the institutional, structural and technical bottlenecks that: *(i)* impede high-value investment and inclusive economic growth; and *(ii)* limit the country's ability to realise its revenue potential. The need to better manage the country's revenue potential is well recognised by the Tunisian authorities. It is particularly pronounced today, with weaker public finances of the post-revolution era on the one hand, and a greater need for domestic financial resources to create an enabling environment for investment on the other.

Principle 1. Make public a statement of all tax incentives for investment and their objectives within a governing framework.

This principle calls for the government of Tunisia to provide justification for granting tax incentives, both in terms of costs and intended benefits, in order to promote transparency in decision-making processes, limit discretion and allow the government to be held accountable for the incentives it grants. In **qualitative** terms, Tunisia adheres to Principle 1. Indeed, the Economic and Social Development Strategy 2012-16, adopted by the transitional government in September 2011, sets clear objectives for the new Investment Code, which guarantee investors a stable, transparent and predictable environment (see Box 1).

> **Box 1. Objectives of the new Investment Code, according to the Economic and Social Development Strategy 2012-16**
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> The new Investment Code will be "simple and transparent, it will translate the new priorities of Tunisia and maximise the impact of investment on development. It will favo[u]r the knowledge economy, qualified employment, balance among regions, skills creation, innovation, productivity, technological development, risk-taking, public-private partnership and global integration through exports, foreign direct investment, and the establishment of Tunisian enterprises abroad. It will enshrine the principle of freedom of initiative and investment and will eliminate the tax and administrative distortions that now exist due to selective and discretionary rules and practices."
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> *Source: Tunisian Economic and Social Development Strategy for 2012-16.*

However, no systematic, institutionalised mechanism exists to **quantify** the effectiveness of the tax incentive measures nor to communicate the costs and benefits of the current or proposed system to policy makers or the public at large. The lack of any form of evaluation of the effectiveness of tax incentives compromises the ability of the Tunisian authorities to adequately and comprehensively assess whether the new Investment Incentives Code will achieve the intended and stated objectives.

Thus, Tunisia would be well advised to establish, at the highest level, preferably within the Ministry of Finance, a well-staffed Fiscal Analysis Unit (FAU) which would have as one of its principal responsibilities monitoring tax policy and the special provisions that deviate from standard tax treatments in order to determine their revenue consequences and likely economic effects. Indeed, on a more general level, any efforts to reform Tunisia's tax system, if they are to lead to sustainable long-term benefits, should include establishing an institution with staff trained in the techniques of modern fiscal analysis and equipped with the necessary tools for putting those techniques to practical use. The role of an FAU in tax policy analysis can be critical to both supporting sound tax policies and exposing the deficiencies in flawed tax reform proposals.

To analyse the effectiveness of tax incentives, the FAU needs to determine whether:

1. the incentives have the desired effect on investment;
2. these effects are achieved at a reasonable price; and finally,
3. the resulting changes in investment actually help achieve the ultimate goals.

Fiscal Analysis Tools. Two of the most important evaluation tools that have to be developed and systematically maintained by the FAU are effective tax rate modeling and comprehensive tax expenditure reporting.

Effective Tax Rate Modeling: To evaluate the extent that various tax incentive measures can have on investment trends in the country, the Tunisian government is advised to develop a Marginal Effective Tax Rate (METR) model. The METR model would allow the authorities to assess the impact of the various tax incentive measures on the rate of return for representative investment projects (at the margin). In addition, METRs can be used in empirical analysis of the sensitivity (elasticity) of investment to taxation, to evaluate the amount by which the level or rate of investment will be affected in response to tax reform. Clear understanding and assessment of the impact of various tax design scenarios is especially critical at the present time, since policy makers are in the process of designing the new Investment Code. Annex B presents illustrative calculations of METRs for Tunisia's onshore and offshore sectors that show a striking difference between the effective rates of the two largely unintegrated segments of the Tunisian economy. Tunisian manufacturers in the onshore regime face a METR of 35.78% while the offshore manufacturing sector enjoys a whole set of incentives reflected in the weighted METR of 4.53%. Tunisian authorities are strongly advised to draw on the OECD's extensive experience in METR modeling to build a robust model that would support policy makers in understanding the impact of the changes that are currently being contemplated for inclusion in the new Investment Code against the intended objectives of the tax incentive system.

Tax Expenditures Reporting: Tax expenditure reports are a useful tool that supports policy makers in addressing economic and social policy objectives. Their primary purpose is to identify the revenue losses associated with tax incentives and, consequently, focus policy makers' attention on the fact that tax expenditures are quite similar to direct spending programmes and (in theory) have to compete with other government spending priorities when the government makes its budget decisions. The Ministry of Finance is capable of calculating the cost of its budgetary tax incentives but: (*i)* no policy-making conclusions or recommendations seem to originate based on those reports; (*ii)* there is no capacity to build a microsimulation model to simulate the cost of the "to be" system of tax incentives, to evaluate the burden of various tax incentives proposals; and (*iii)* no institutionalised mechanism exists to communicate the cost of either the current or the "to be" tax incentive system to either Tunisian policy makers or the public at large.

At the time this report is written, a World Bank/IFC team is completing a comprehensive tax expenditure analysis. The government of Tunisia would be advised to benefit from the World

Bank/IFC team in building its own capacity in tax expenditure reporting and microsimulation modeling.[7] Furthermore, Tunisia would be strongly advised to institutionalise a mechanism for disclosing the cost and intended benefit of the current and/or proposed tax incentive regimes to the key stakeholder groups, to seek feedback and allow for stakeholders' involvement in the design of tax incentive measures prior to their adoption (see the section entitled "*Stakeholder Roles and Responsibilities* for more information on the latter point).

Principle 2. Provide tax incentives for investment through tax laws only.

The 1993 Investment Incentives Code ("the Code") is the main point of reference, both for domestic and foreign investors. It governs most activities, with the exception of certain sectors such as finance, mining and energy, which are covered by specific legislation. However, the system instituted by the Code has become complex and lacks transparency for investors. It has been amended 64 times since 1993. Out of its 67 articles, 43 have been revised, some more than once. This complexity increases the compliance burden for investors and makes it harder for the tax administration to administer the tax system.

One of the most essential aspects of the reform package undertaken by the new Tunisian authorities is the preparation of a new Investment Code. This is in response to investors' perception that the current Code is excessively complex, as well as the Tunisian authorities' recognition that the lack of transparency and undue complexity of the legislative and regulatory frameworks must be addressed to enable a conducive and dynamic business environment.

At the time of writing, the Tunisian authorities were fully engaged in developing the new Investment Incentive Code. A meaningful evaluation of Tunisia's adherence to Principle 2 can only be conducted once the draft of the new Code is made public. The Tunisian authorities are advised to consolidate all legislative elements related to investment incentives within the body of one single new Code. Ultimately, all laws with tax implications should be reflected within the body of the Tax Code (even if the provisions are duplicated).

Principle 3. Consolidate all tax incentives for investment under the authority of one government body, where possible.

One striking feature of the Tunisian investment landscape is the presence of a number of institutions responsible for investment promotion and facilitation, including but not limited to:

- the Agricultural Investment Promotion Agency (APIA) for agriculture and fishing activities;
- the Tunisian National Tourism Office (ONTT) for tourism activities;
- the Tunisian National Handicrafts Office for handicrafts;

[7] The development and publication of a tax expenditure budget would be one particularly useful undertaking of the FAU.

- a unit of the Ministry of Information and Communication Technologies (CPTIC) for ICT projects;
- the Agency for Promotion of Industry in Innovation (APII) for industrial and all remaining activities.

A network of Public Economic Interest Business Centers (*Centres d'affaires d'intérêt public économique*, CAIPE) serves to facilitate business project implementation. Furthe, the Foreign Investment Promotion Agency (FIPA) is responsible for promoting foreign direct investment (FDI), and the Export Promotion Centre (CEPEX) concentrates on exports. It has to be noted that most of these agencies operate as a network and have numerous branches and representations, either domestically or abroad.

An obvious question is whether, for a small country like Tunisia, consolidating these institutions would help to avoid unintended waste and overlap. Furthermore, and perhaps more importantly, consolidating these institutions will help to avoid inconsistent application of investment incentive measures, which is unavoidable under the current arrangement. As an example, submitting an investment declaration (which entitles one to tax incentives) to APIA could grant an investor a set of tax incentives which is different from the incentives the investor would have been granted had the investment declaration for the **same** investment been submitted to APII. The investor must himself figure out which agency will grant him a better "treatment". Clearly, smaller investors, with limited capacity to evaluate the intricacies of a complex Investment Code, are most disadvantaged by the current arrangement.

In addition, Tunisia is clearly lacking inter-agency co-ordination of the institutions involved in managing tax incentives (from approval to administration). One arrangement that exists is that when an agency approves an investment application, a copy of the approved application is submitted to the revenue authorities with a tax declaration. The revenue authorities are required to grant the investor a relief provided for in the taxation laws. However, the revenue authority does not play any role in the approval, verification or valuation of the investment, and no inter-agency co-ordination or information exchange exists once the declaration has been approved. This absence of proper inter-agency co-ordination provides fertile ground for serious levels of tax avoidance and abuse.

Tunisian authorities are strongly advised to institutionalise an inter-agency electronic information exchange system, with an inter-agency registry of investment declarations accessible by tax authorities in real time. This will increase transparency, help to avoid inconsistencies in the application of incentive policies, limit discretionary power and rent-seeking, and help to address problems that may arise with the governance of tax incentives.

Principle 4. Ensure tax incentives for investment are ratified through the law-making body or Parliament.

The tax incentives legislation process in Tunisia is largely transparent. Common and specific tax incentives are defined in the Investment Incentives Code. The process of developing a new Investment Code (to replace the current one of 1993) has been announced by the interim government. The Ministry of Investment and International Co-operation (MICI) has established a special group of experts – COMEX – drawn from the key Tunisian ministries and agencies, to design the new Code. Working with key stakeholder groups, international organisations, independent consultants and academia, COMEX is deliberating various policy options. At the end of the deliberation process, the draft version of the new Code will be submitted to MICI, which in turn will present it to the Constituent Assembly to be debated and consequently ratified.

However, as discussed above, the lack of any form of evaluation of the effectiveness of the proposed tax incentives measures handicaps the legislative process. It compromises the ability of Tunisian policy makers to adequately defend the proposed measures, and of Tunisian legislators to adequately assess whether the new Investment Incentives Code will indeed achieve its intended objectives.

Principle 5. Administer tax incentives for investment in a transparent manner.

Incentives regimes are prone to tax avoidance. As such, an assessment of the impact of tax incentives on the administrative capacities of tax administrations and the compliance behaviour of taxpayers cannot be overemphasised. Tax incentives that do not take into account the limitations of the tax administration's capabilities have been proven to be cost-ineffective (i.e. bring in less than a dollar of investment for each dollar lost in government revenues). They frequently result in the development of creative schemes to pass along tax benefits to other activities or in outright fraud through improper accounting, such as reporting expenditures for activities that are not entitled to the incentives as if they were so entitled.

As an example, the provision of the Tunisian Code that allows for tax relief of reinvested earnings and profits granted on the basis of a declaration of investment intent, is easily subject to abuse by Tunisian taxpayers. A simple declaration of intent to reinvest industrial activity earnings into an agricultural activity affords an effective tax rate reduction of at least 10%. The anecdotal evidence suggests that the problem of Aladdin's lamp ("new firms for old") is also common as old firms are reconstituted as new ones at the end of their holiday period, so that they can continue to be tax-exempt. Similarly, channeling asset purchases through qualifying companies on behalf of non-qualifying ones is evidently a "popular" technique in Tunisia.

The ability of taxpayers in the Tunisian offshore regime to avoid the tax administration poses administrative difficulties since the administration "loses contact" with the taxpayer, thereby undermining its ability to effectively monitor fraudulent activities (including various transfer price schemes), as well as limiting policy makers' ability to estimate revenue losses associated with the offshore regime. From the tax administration's perspective, giving increased attention to offshore firms does not yield a revenue pay-off commensurate with the incurred costs. This argument provides both a strong political rationale against deploying additional tax administration resources and further opportunities for "offshore" taxpayers to abuse the rules with little fear of reprisal.

When asked about the tax administration's capacity, one of the key Tunisian government officials noted: "Tax administration capacity is weak but we are lucky that most of the tax incentives provided by the 1993 law are not used by investors." We conclude this section by suggesting that:

- Tunisian policy makers design the incentive regime so that it is commensurate with the capabilities of the tax administration to manage and administer it. Poorly designed tax incentives can impose additional indirect costs on society which should be considered in the analysis of their effectiveness.

- Any provisions over which tax authorities have discretion as to their application create opportunity and incentives for corruption as firms try to "convince" authorities to accept their applications. Firms involved in other activities will spend resources trying to convince government officials to grant them special treatment. These are issues for the legal system and monitoring them involves definite costs to society. Currently in Tunisia, where monitoring of such activity is limited, such opportunities should be minimised by the government.
- Tax authorities should build capacity to effectively monitor tax incentives claims (including access to an electronic registry of investment declarations) and periodically carry out audits of cases where tax incentives have been claimed to ensure that they are not misused.

Principle 6. Calculate the amount of revenue forgone attributable to tax incentives for investment and publicly release a statement of tax expenditures.

Tax expenditure budgeting is a valuable method for monitoring the amount of foregone revenue from tax incentives. There are several powerful reasons for governments to document and track their tax expenditures:

- **Efficiency.** Tax expenditure estimates permit a comparison of the indirect costs of programmes with alternative means of achieving similar objectives. These alternatives may be either direct expenditures or other tax expenditures.
- **Accountability.** Tax expenditure estimates increase public knowledge of government activities and objectives and permit the public to more easily track and assess changes in government policy.
- **Equity.** Since the benefits of a tax expenditure are directly related both to the tax status of the potential recipient and to other provisions in the tax code, their effect is frequently uneven across taxpayers, violating the tax principles of horizontal and vertical equity. Tax expenditure quantification helps to focus attention on the tax system's structure and forces policy makers to question whether each of the various deviations is justifiable.
- **Effect policy through the tax system.** Finally, the identification and quantification of tax expenditures results in government's realisation that economic and social policy may be affected not only through direct expenditures and transfers, but also indirectly through the tax system.

The Ministry of Finance calculates the cost of its budgetary tax incentives based on the revenue loss (foregone) method, which is an *ex post* quantification of the extent to which a provision reduces revenues. The immediate revenue losses only represent the **direct** costs to the economy that the tax incentives introduce. Further distortions, **indirect** costs, include administrative costs from running tax incentives and prevention measures against fraudulent incentives schemes, as well as the social costs of rent-seeking behaviour, including corruption.

Even the direct revenue costs of incentives are difficult to quantify. If the investment would not have been made in the absence of tax incentives, the direct revenue loss is effectively zero. However, if incentives have no effect on investment, then the entire forgone tax revenue constitutes a revenue loss. The true amount of direct revenue losses is likely to be between these two extremes.[8] Based on data from the Ministry of Finance, Professor Ghazouani of the University of Carthage reports that the average **direct** cost of tax incentives in Tunisia stood at 2.14% of GDP between 1994 and 2007.[9] A World Bank/IFC team is completing a comprehensive tax expenditure analysis for Tunisia.[10] Their estimate of tax expenditures is even higher, but at the time this report was written, the final analyses were not yet available.

The government of Tunisia is advised to institutionalise the process by which the revenue loss attributable to tax incentives is regularly estimated and reported, ideally as part of an annual Tax Expenditures Report (covering all of the main tax incentives). The development and publication of a yearly tax expenditure budget would be one of the particularly useful undertakings of the FAU (discussed under Principle 1).[11] Moreover, capacity needs to be built to create and maintain microsimulation models that would allow revenue losses due to various tax incentive proposals to be evaluated by Tunisian policy makers.

Principle 7. Carry out a periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives.

Constant vigilance is the price to be paid for a tax law that includes investment incentives and other tax preferences. A review of the current tax structure in Tunisia reveals that the system creates an incentive to substitute capital for labour. A bias in favour of capital-intensive production may be appropriate under certain circumstances, depending on the nature of the presumed externalities that justify the granting of tax preferences, for example a technology transfer embodied in capital goods. This bias could have been appropriate in the 1970s, but it has been showing its limitations with the emergence of a new, educated and skilled workforce in Tunisia, at a time when the creation of high-skilled jobs is one of the main priorities for the country. Furthermore, highly incentivised sectors do not do enough in terms of technology transfer to justify preferential treatment.

The 1993 Investment Incentives Code institutionalised an asymmetrical regime between enterprises wholly engaged in export (offshore) and those geared to the domestic market (onshore), under which the former benefits from financial and tax advantages and exemption from approvals. If systematically conducted, an assessment of the current tax incentives system would have revealed that the impact of the special status granted to the offshore sector is modest in terms of job creation and the quality of those jobs. There is little effect on real wages and the system did not induce many indirect jobs. What's more, the favourable treatment accorded to the offshore sector, in fact, came at the expense of the onshore sector,

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[8] Note that if an offshore investment is crowding out a highly taxable onshore investment, the indirect revenue loss effects are not negligible and should also be considered.

[9] Kamel Ghazouani (2011), *Evaluation of Investment Incentives*, Tunisian Center for Economic Studies.

[10] No estimations of institutional/administration or other indirect costs are included.

[11] Morocco is the only MENA country to elaborate a Tax Expenditure Report, which has been integrated into the government's budget process.

and domestic production does not receive comparable support from the authorities. Lastly, "fly-by-night", or short-lived, investment is in a more favourable situation in the current tax incentives environment compared to long-term investment. Since tax holidays of the offshore regime benefit industries that start making a profit during the holiday period, a favourable tax bias exists for short-term projects and short-term assets.

We conclude this section by suggesting that periodic assessment of the performance of tax incentives be conducted systematically in Tunisia. Performance reviews should include an analysis of both the costs and the benefits of the tax incentives with a goal to understand:

- whether the current system meets its intended goals;
- if other measures could have achieved the same goal in a more cost-efficient manner;
- what measures could be proposed to address the most pressing priority of the country and what will be the burden of the proposed measures.

Also, the Tunisian authorities are strongly advised to build capacity in effective tax rate analyses, similar to the one presented in Annex A of this report. The marginal effective tax rate (METR) modeling can be used to assess the impact of tax policy reforms to the level of investment across different:

- types of capital (machinery, buildings, inventories, land);
- sectors/industries (manufacturing, agriculture, services, other);
- shareholder groups (taxable, tax-exempt, non-resident);
- regions;
- size.

Of critical importance at the present time, when Tunisian policy makers are designing the new Investment Incentives Code, an METR model could be used by tax incentives policy analysts in understanding the impact of various design scenarios against the intended objectives of the system.

Principle 8. Highlight the largest beneficiaries of tax incentives for investment by specific tax provision in a regular statement of tax expenditures, where possible.

It has been widely recognised that the old regime's system of clienteles allowed enterprises to benefit from significant exemptions and incentives. Surveys conducted by the Arab Institute of Chief Executives (*Institut arabe des chefs d'entreprises*, IACE) in 2011 also showed that the lion's share of the advantages was captured by a minority of large firms,[12] to the detriment of smaller firms. A lack of transparency on the cost and benefits of tax incentives prevents policy makers and the public alike to adequately scrutinise them. Our analysis suggests that the offshore sector is the largest beneficiary of the Tunisian tax incentives system at the expense of the onshore sector and indeed of the country as a whole. The revenue lost due to special tax provisions translates into less available money for other public

[12] Ghali, S. (2011), *Attractivité des investissements: quelques pistes de réflexion*, Journées de l'entreprise 2011, IACE, December.

expenditures, such as infrastructure development of disadvantaged regions, investments in public education, health and security.

The Tunisian authorities are advised to conduct a thorough analysis of the winners and losers of the tax incentives system. Tax expenditure reporting could list the major beneficiaries and the amount by which they benefit from tax incentives. Making such information public can enhance the legitimacy of governments and their revenue authorities in the eyes of citizens, which in turn can enhance compliance more broadly.

Principle 9. Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives.

Accurate, complete, current, consistent and reliable data is crucial in enhancing the effectiveness and efficiency of a tax incentives policy. At this stage, the Tunisian authorities are experiencing difficulties in attempting to integrate and leverage common inter-agency data. Various agencies, holders of relevant information, have different classification systems, which lack common definitions and structure. This complicates data integration and necessitates mapping one classification system against another.

The technological foundation exists in Tunisia to establish a reliable single-source data store and framework. According to the 2010 United Nations E-Government Survey, Tunisia ranks first among African countries in the application of ICTs in government, and 66th worldwide among 192 countries evaluated. What is needed now is an important exercise of indexing, classifying and linking information and databases together. A common data identifier must be developed as soon as possible. A holistic, unified data and centralised data storage infrastructure that breaks current “information silos” will serve analysts in economic and tax analyses and modeling. That, in turn, will support Tunisian policy makers in taking effective strategic decisions with regard to both specific tax incentive measures and in addressing broad macroeconomic goals.

Principle 10. Enhance regional co-operation to avoid harmful tax competition.

Open economy considerations and increasing globalisation impose constraints on Tunisia’s ability to pursue independent policies and puts pressure on policy makers to keep effective marginal rates in line with other countries. That is why the issue of tax incentives cannot be tackled in isolation. The government of Tunisia is advised to work together on a regional basis with other Maghreb countries to increase co-operation in the area of tax to avoid competing tax incentives.

Stakeholder roles and responsibilities

The current mechanisms for stakeholder consultation, including for the development of the Incentives Code, do not allow for effective discussion and adequate consideration of private sector concerns on investment incentives issues. As Tunisia moves away from its former regime, new opportunities exist to build a broad-based consultative process and ownership around the government's visions (development goals as reflected in the Economic and Social Development Strategy 2012-16).

The Tunisian authorities are advised to institute a consultation process involving stakeholders (a Stakeholder Consultative Committee) where the private, public, civil society and academic sectors work together to enhance the country's competitiveness. Broader stakeholder participation validates the relevance of the reforms, conveys ownership and ensures that reform activities are sustained. In addition, the stakeholders become change agents as they participate in a consultative process contributing to the government's priorities and supporting implementation. Tunisian policy makers are strongly encouraged to reinvigorate consultations and strengthen their role in the development and implementation of the new Code. Public-private dialog is essential to identify areas of concern and develop collaborative solutions to continue to sustainably improve Tunisia's investment environment.

5. Concluding Remarks

In remodeling its tax incentives system, Tunisian policy makers are facing several constraints, which may be characterised as international, institutional or technical:

- ***International.*** Open economy considerations and increasing globalisation imposes serious constraints on Tunisia's ability to pursue independent policies and puts pressure on policy makers to keep effective marginal rates in line with those of other countries.
- ***Institutional.*** Analytical complexities, coupled with limited institutional and human capacity to undertake advanced analysis, limit the Tunisian government in assessing the consequences of changes in the tax/investment system.
- ***Technical.*** The lack of sufficient and well-organised data limits the ability of the Tunisian authorities to quantify both the performance of the existing system and the implications of introducing new policies.

Taking these constraints into account, the Tunisian authorities are advised to:

- Build and institutionalise capacity in tax policy analysis to improve comprehension of the effectiveness of the current and proposed tax incentive measures in achieving the intended objectives.
- Address the lack of transparency and undue complexity of the current legislative and regulatory framework in order to enable a conducive and dynamic business environment.
- Consolidate the investment agencies to prevent unintended waste and overlap, and avoid inconsistent application of investment incentive measures, which is unavoidable under the current arrangement.
- Institutionalise the process by which the revenue loss attributable to tax incentives is regularly estimated and reported, ideally as part of an annual Tax Expenditures Report (covering all of the main tax incentives).
- Build a centralised data storage infrastructure that breaks current "information silos" and serves policy analysts in economic and tax analyses and modeling.

- In designing the new Investment Incentive Code, consider the following:
  - *A cleaner income tax system with few preferences of any kind, a broad tax base and moderate tax rates is much preferred to any alternative structure on both administrative and policy grounds.* The presence of tax incentives erodes the clear standard of a broad-based, low-rate tax system that serves the ends of both economic efficiency and stability in the system. Absent such a standard that is consistently adhered to, there is little defense against the pleading of the special interests that can always make plausible arguments as to why their case, and their tax preference, is meritorious.
  - *At the least, the newly-designed incentives system must reduce the dichotomy between the offshore and onshore regimes, and remove the bias towards short-lived investment.* The notion behind the level playing field is stood on its head in Tunisia. Rather than the strong economic position that all sectors and industries are treated uniformly, and all benefit from lower rates, the argument reverts to a series of comparisons between the preferred activities and all others. The playing field is always tilting as political pressures dictate.
  - *It must be acknowledged that not all forms of tax preferences or investment incentives are equally objectionable.* Tax holidays are clearly the most problematic. General incentives in the form of, say, investment tax credits or accelerated depreciation that, depending on the precise form and degree of the acceleration, could apply to all activities and maintain reasonable neutrality. The trade-off would still exist between such a system and one with a broader base and lower rates, but the administrative problems and large-scale opportunities for abuse would be greatly diminished.

Annex A: Overview of Incentives in Tunisia[13]

Common incentives	
	• Capital allowance of 35% of income/profits subject to income/profit tax if reinvested in share capital or invested in capital increase. • Exemption from customs duties and VAT for imported capital goods that do not have a locally manufactured equivalent. • Suspension of VAT payment for locally manufactured equipment purchased before the enterprise enters into production. Payment of VAT (12%) for locally acquired equipment after production startup activity.
Specific incentives	
Fully exporting companies	• Full tax exemption for the first 10 years; rate of 10% thereafter. • Full capital allowance on reinvested income/profits. • Exemption of customs duties and VAT for all capital goods required for export operations, including merchandise transport vehicles, raw materials, semi-finished products, and services. • Opportunity to sell up to 30% of turnover on the local market.
Partially importing companies	• Full tax exemption of profit from exports for the first 10 years; rate of 10% thereafter. • Exemption of customs duties and VAT on the goods, products and services required for export operations. • Reimbursement of customs duties on raw materials and semi-finished products imported or acquired on the local market for export operations.

Incentives for regional development	***Fiscal Incentives***
	• Full capital allowance on reinvested income/profits.
	• Income/profit tax exemptions as follows:
	  ○ **First Group:**[14] 100% for the first 5 years of operation.
	  ○ **Second Group:**[15] 100% for the first 10 years of operation.

[13] Source: the Investment Incentives Code, 1994; 1999 Finance Act provisions; Law n°2007-69 of 27/12/2007.

[14] The **First Group** includes the following governorates and delegations: Béja (Medjez, el Bab); Sfax (Agareb, Djebeniana, El Amra, El Hancha, El Ghraiba, Skhira); Sousse (Sidi El Hani); Zaghouan (Zaghouan, Bir M'cherga).

[15] The **Second Group** includes the following governorates and delegations: Béja (Béja nord, Béja sud, Testour, Teboursouk, Goubellat, Tibar); Bizerte (Djoumine, Ghezala); Gabès (Mareth); Kairouan (Kairouan nord,

- **Priority Zones:**[16] 100% for the first 10 years of operation and 50% for the following 10 years.

- Exemption from contributions to the housing fund for wage earners, for the Second Group and the Priority Zones.
- Exemptions (full or partial) from employers' contribution to the social security system (CNSS):
  - **First Group:** For the first 5 years of operation: 100% in Year 1, 80% in Year 2, 60% in Year 3, 40% in Year 4 and 20% in Year 5.
  - **Second Group:** 100% for the first 5 years of operation.
  - **Priority Zones:** 100% for the first 5 years of operation; for the following 5 years of operation: 100% in Year 6, 80% in Year 7, 60% in Year 8, 40% in Year 9 and 20% in Year 10.

Financial Incentives

- Financial investment incentives include:
  - **First Group:** 8% of the investment cost, not to exceed TND 500 000.
  - **Second Group:** 15% of the investment cost, not to exceed TND 1 million.
  - **Priority Zones:** 25% of the investment cost, not to exceed TND 1.5 million.
- Financial incentives for the state to participate in infrastructure investment:
  - **First Group:** 25% of the investment cost.
  - **Second Group:** 75% of the investment cost.
  - **Priority Zones:** 85% of the investment cost.

Kairouan sud, Hajeb el Ayoun, Echebika, Sbikha, Haffouz, Nasrallah, Bouhajla, Cherarda); Mahdia (Ouled Chamekh, Hébira, Essouassi, Chorbane); Médenine (Médenine nord, Médenine sud, Sidi Makhlouf, Ben Guerdane); Sfax (Bir Ali ben Khélifa, Menzel Chaker); Sidi Bouzid (Sidi Bouzid Ouest, Sidi Bouzid Est, Mezzouna, Regueb, Ouled Haffouz); Siliana (Bou Arada, Gaâfour, el Krib, El Aroussa); Zaghouan (Ez-Zriba, el Fahs, Saouaf).

[16] The **Priority Zones** include the following governorates and delegations: Beja (Nefza, Amdoun, Testour, Teboursouk, Goubellat, Tibar); Bizerte (Sejnane); Gabes (Old Matmata, New Matmata, El Hamma, Menzel el Habib); Gafsa (All delegations); Jendouba (All delegations); Kairouan (El Ala, Oueslatia); Kasserine (All delegations); Kebili (All delegations); Le Kef (All delegations); Medenine (Beni Khedeche); Sfax (El Ghraiba, El Amra, Agareb, Djebeniana, Skhira, Kerkennah); Sidi Bouzid (Bir El Hafey, Sidi Ali Ben Aoûn, Menzel Bouzaïenne, Jilma, Cebalet Ouled, Asker, Meknassy, Souk Jedid); Siliana (Siliana Nord, Siliana Sud, Bou Rouis, Bargou, Makthar, Er-Rouhia, Kesra); Tataouine (All delegations); Tozeur (All delegations); Zaghouan (Ez-Zriba, Ennadhour, Saouaf).

Agricultural development	***Fiscal Incentives*** • Full capital allowance of income/profits subject to income/profit tax if reinvested or invested in capital increase. • Full deduction from the tax base of income and profits from investment in agriculture for the first ten years of operation. • Exemption of customs duties and VAT for imported capital goods that have no locally manufactured equivalent. ***Financial incentives:*** • Monetary benefit of 7% on investment value. • Additional benefit of 8% on agricultural investments in hard-climate regions: Gabes, Gafsa, Kebili, Medenine, Tataouine and Tozeur. The benefit can be as high as 25% for areas around Gafsa which are in the process of converting from mining to other activities. • Additional 25% benefit for fishing projects for north coastline ports from Bizerte to Tabarka.
Environmental protection	• Capital allowance of 50% of income/profits subject to income/profit tax if reinvested or invested in capital increase. • Income and profits taxed at a reduced rate of 10%. • Exemption from customs duties and VAT for imported capital goods that have no locally manufactured equivalent. • Financial incentive of 20% on the value of investments.
Support investment	Education, training, cultural production, health and transport industries benefit from a: • deduction of reinvested profits up to 50% of net profits subject to corporate tax; • reduced rate of 10% on income and profits; • VAT suspension for imported capital goods having no similar locally made counterparts.
Additional incentives	Additional incentives are available for investment in research and development and technology promotion, as well as for investment activities in education, training, cultural production, health and transport industries. Furthermore, special incentives are available for new investors and SMEs. Overviews of these additional fiscal and financial incentives can be found at *www.investintunisia.tn/site/en/article.php?id_article=789* and *www.tunisianindustry.nat.tn/en/home.asp*.

Further highlights of the taxation regime in Tunisia

Provision	Detail
Statutory tax rate	The regular rate is 30%. A 35% rate applies to certain banking activities, investment companies, insurance and reinsurance companies, factoring companies and telecom companies. A lower rate of 10% applies to agricultural, health, handicraft companies and education activities.
Taxation of dividends	Dividends distributed by Tunisian companies are not subject to tax in Tunisia.
Capital gains	Capital gains are taxed as ordinary income and subject to the corporate income tax rate applicable to the company.
Capital taxes	None.
Losses	Net operating losses may be carried forward for up to four years. The carry back of losses is not permitted.
Depreciation	For tax purposes, the straight-line method is normally adopted. Assets aless than TND 200 may be fully written off during their first year. Companies may choose the declining-balance method to calculate depreciations on hardware, agricultural equipment and newly purchased manufacturing equipment (from 1 January 1999). From 1 January 2008, a company is eligible to use the declining-balance method to compute depreciations on manufacturing equipment financed by leasing.
Property Transfer Tax/fees	The transfer of property located in Tunisia is subject to various registration fees, such as a 5% transfer tax, a 3% tax for unregistered property and a 1% tax for the land conservation authorities.
VAT	The standard VAT rate is 18%. Reduced rates are applicable for some activates: • The rate of 12% is applicable, for example, to raw materials, craft industry products, medical activities, the transport of goods excluding agricultural and fish products, services rendered to hotels, services rendered by lawyers, tax counsels and other experts, etc. • The rate of 6% is applicable, for example, to information technology services, hotels and restaurant activities, equipment, activities carried out by doctors, analytical laboratories, articles for pharmaceutical products, the transport of persons, agricultural and fish products, etc. Exports are zero-rated.

Annex B: Marginal Effective Tax Rates (METRs) modeling

Important note: *We would like to emphasise that the METR calculations presented here are for illustrative purpose only. Final conclusions can only be drawn from this analysis once all of the assumptions are validated by the Tunisian authorities.*

The methodology for estimating marginal effective tax rates (METRs) is extensively documented.[17] We are using the standard methodology as discussed in Chen and Mintz (2008)[18] and a set of assumptions to demonstrate METR calculations for offshore and onshore regimes in Tunisia.

The standard theory of investment defines METR as

$$METR = \frac{r^G - r^N}{r^G} \qquad (1)$$

Where r^G is the pre-tax rate of return (at the margin) required by an investor and r^N is the after-tax rate of the return (at the margin).

We begin by calculating the r^N, net-of-tax rate of return on capital, defined by the formula

$$r^N = \beta i + (1 - \beta)\rho - \pi \qquad (2)$$

where β is the debt-to-assets ratio, i is the nominal interest rate on debt finance, ρ is the nominal required rate of return on equity, and π is the inflation rate. For this illustrative example we are assuming that the investment is 30% debt- and 70% equity-financed, with β equal to 0.3. We are setting the inflation rate π at 3.75%. Under the small open economy assumption, the financing costs for Tunisia are determined by international capital markets, therefore personal taxes on dividends, interest and capital gains do not affect the cost of financing. Given the known international real interest rate of 4%, i = 7.75% and ρ = 7.75%.

Based on (2), r^N =4.00%.

Onshore regime

We then proceed to calculating the real cost of funds, r^f, for key sectors of the Tunisian economy under the onshore regime

$$r^f = \beta i\,(1 - U) + (1 - \beta)\rho - \pi \qquad (3)$$

where U is a statutory corporate income tax rate that is different for various sectors, as presented below.

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[17] See for example:

- OECD (1995), "Taxation and Foreign Direct Investment: The Experience of the Economies in Transition", OECD, Paris.
- McKenzie, K.J., M. Mansour and A. Brûlé (1998), "The Calculation of Marginal Effective Tax Rates".
- Mintz, Jack M. (1995), "Tax Holidays and Investment", in Shah, A. (Ed.), *Fiscal Incentives for Investment and Innovation*, Oxford University Press, New York.

[18] Chen, Duanjie and J. Mintz (2008), "Taxing Business Investment: A New Ranking of Effective Tax Rates on Capital".

	Agriculture and fishing	Manufac-turing	Non-manufac-turing	Oil and natural gas	Services	Financial services	Telecomm unication	Transport	Other services
U_j	10%	30%	30%	35%	30%	35%	35%	35%	30%

Consequently, r^f for each sector j is:

	Agriculture and fishing	Manufac-turing	Non-manufac-turing	Oil and natural gas	Services	Financial services	Telecomm unication	Transport	Other services
r^f	3.768%	3.303%	3.303%	3.186%	3.303%	3.186%	3.186%	3.186%	3.303%

Next, we calculate the r^G, the pre-tax rate of return (at the margin), for the onshore regime, assuming a declining-balance depreciation of assets. r^G is calculated for depreciable assets: building and machinery. For depreciable assets r^G is defined by:

$$r^G = (1 + \mu)\,(r^f + \delta)\,(1 - k)\left(\frac{1 - A + \dfrac{c^t\,(1 - U)}{(r^f + \pi + \alpha)}}{(1 - U)\,(1 - t^p)} \right) - \delta \tag{4}$$

where μ is the non-creditable transaction tax (such as import duty and sales tax) on capital goods; δ is the economic depreciation rate; k is the investment tax credit rate; A is the present value of future tax savings from depreciation allowances, defined below, c^t is the capital tax rate, α is the tax depreciation rate, t^p is the property tax rate.

There is no capital tax in Tunisia, so c^t. No property tax is levied, therefore $t^p = 0$. Similarly, no investment tax credit is allowed, therefore $k = 0$.

The expression for A – the present value of future tax savings from depreciation allowances – for a declining-balance depreciation schedule is defined as:

$$A = \frac{U\,\alpha}{\alpha + r^f + \pi} \tag{5}$$

For this illustrative example, we assume that:

- **For Buildings:** $\mu = 6\%$; $\delta = 5\%$; $\alpha = 10\%$
- **For Machinery:** $\mu = 12\%$; $\delta = 15\%$; $\alpha = 25\%$.

The table below shows values for r^G, derived based on (4) and (5).

	Agriculture and fishing	Manufac-turing	Non-manufac-turing	Oil and natural gas	Services	Financial services	Telecomm unication	Transport	Other services
Buildings	4.74%	5.36%	5.36%	5.59%	5.36%	5.59%	5.59%	5.59%	5.36%
Machinery	6.56%	7.43%	7.43%	7.75%	7.43%	7.75%	7.75%	7.75%	7.43%

With the above values and assumptions, based on (1), METRs for depreciable assets in the sectors of the onshore regime are equal to:

	Agriculture and fishing	Manufac-turing	Non-manufac-turing	Oil and natural gas	Services	Financial services	Telecommunication	Transport	Other services
METR	27.29%	35.78%	35.78%	38.42%	35.78%	38.42%	38.42%	38.42%	35.78%

Offshore regime[19]

We conducted a similar analysis for Tunisia's offshore regime which enjoys a ten-year tax holiday and a reduced rate of 10% thereafter. The tax value of the depreciation write-off includes the 35% initial allowance for reinvestment profit and annual depreciation allowances before and after the holiday.

$$r^G = (1 + \mu)\,(r^f + \delta)\,\frac{\delta\,(1 + \pi) - (\alpha + \pi)\,u_1\,(1 - \gamma)\,\dfrac{(1 + i)\,\alpha}{\alpha + i}\,\left(\dfrac{1 - \alpha}{1 + i}\right)^{t^* - t}}{1 + \pi} - \delta \qquad (6)$$

Where t^* is the moment when the tax holiday ends and the firm becomes fully taxable, and μ is the rate of the initial allowance.

With the above values and assumptions, based on (6), METRs for the sectors of the offshore regime are equal to 4.53%, in striking contrast to the METRs of the onshore sector (reflected in the table above).

Policy implications: Some obvious conclusions can be drawn from the above analysis, even before the assumptions are verified and the missing data is obtained. Tunisian authorities are advised to modify the tax system in a manner that reduces the extraordinary difference between the effective rates of the onshore and offshore regimes. For example, Tunisian manufacturers in the onshore regime face a tax burden as a high weighted average METR of 36.51% versus the offshore manufacturing sector which enjoys a whole set of incentives reflected in the weighted METR of 4.53%.

If politically acceptable, a cleaner income tax system, with few preferences of any kind, broad tax bases and moderate tax rates (reflected in lower METRs) that restore a level playing field in Tunisia, is much preferred to any alternative structure. In the second-best scenario, a smartly designed system would move away from tax holidays and consider the use of investment allowances and tax credits instead.[20]

[19] The discussion here closely follows the one in Mintz, Jack M. (1995), "Tax Holidays and Investment", in Shah, A. (Ed.), *Fiscal Incentives for Investment and Innovation*, Oxford University Press, New York. Please refer to the source for the derivation of variables.

[20] Note, however, that these incentives encourage investment in physical, rather than human, capital.