Reformulating the Tax Incentive Program in Jordan: Analysis and Recommendations

Final Report

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ABSTRACT

The primary objective of this report is to assist Jordan's Minister of Industry & Trade and Minister of Finance to formulate a new program of investment incentives, based on international best practice, to be used as the basis for regulations to support "The Investment Law of 2003." The authors evaluate current incentives in Jordan and other countries, and recommend new ones to make Jordan a more attractive destination for direct investment.

ABBREVIATIONS AND ACRONYMS

AED	Arab Emirates Dinar
AMIR	Achievement of Market-friendly Initiatives and Results Program
ASEZ	Aqaba Special Economic Zone
CAEC	Convention and exhibition centers
CIT	Corporate income tax
DB	Declining-balance method of accounting
EGP	Egyptian Pound
GDP	Gross domestic product
GST	General Sales Tax (Jordan's value-added tax)
IPL 1987	Investment Promotion Law of 1987
IPL 1995	Investment Promotion Law of 1995
IBFD	International Bureau of Fiscal Documentation
JD	Jordanian Dinar
JIB	Jordan Investment Board
JIEC	Jordan Industrial Estates Corporation
JIECL 1985	Jordan Industrial Estates Corporation Law of 1985
LARC	Leisure and Recreational Compounds
M&E	Machinery and Equipment
MTR	Maritime Transport and Railways
N/A	Not applicable
SL	Straight-line method of accounting
SME	Small- and medium-sized enterprise
TDWGO	Transportation and Distribution of Water, Gas, and Oil
UNCTAD	United Nations Conference on Trade and Development
USAID	United States Agency for International Development

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EXECUTIVE SUMMARY

The primary objective of this report is to assist Jordan's Minister of Industry & Trade and Minister of Finance in formulating a new program of investment incentives, based on international best practice, to be used as the basis for regulations to support "The Investment Law of 2003."

We have not been requested to propose changes to the current tax structure under which the existing investment incentive program was formulated. In our opinion, however, the reformulation of incentives under The Investment Law should be undertaken as an integral part of a comprehensive tax reform, as envisaged by the *Jordan Vision 2020* development plan. This plan, which has been endorsed by Jordan's leading figures in industry and government, establishes a roadmap for the country to distinguish itself as an economic innovator, following the successful examples of developing countries like Ireland and Singapore. For this to occur, the plan states "efficiency, fairness, transparency, and even-handed application should be hallmarks of Jordan's tax system." (See Annex 2 for the scope of work of this consultancy.)

Jordan's current investment incentive program is too complicated and inefficient. It is overly selective in the sectors and regions it favors, the conditions for exemption it offers, and the periods to qualify for tax incentives that it requires. The following five points summarize the main weaknesses of Jordan's current incentive program.

- The income tax reductions for selective sectors categorized by development zones significantly worsen the tax distortion arising from the existing multi-leveled income tax rates.
- The program's use of tax holidays is not necessarily an effective means of attracting large-scale, long-term capital investment.
- The current conditions required to obtain import duty exemption for fixed assets are too restrictive and obsolete.
- The narrowly defined sectoral coverage of the program creates an environment that encourages interest groups to seek even more selective incentives, so that government has to increase taxation on the economy as a whole to meet revenue targets.
- All of the current incentives require bureaucratic pre-approval. This administrative discretion is unnecessary and undesirable.

Because of these weaknesses, Jordan's long history of investment incentives has proven not to attract significant capital investment in areas favored by government. Instead, these measures have simply eroded the base for tax revenue. (See Chapter 2 for further information.)

In order to quantify the distorting effect of the current investment incentive program, we apply the tool of marginal effective tax rate (METR) analysis. METR measures the overall cumulative tax burden incurred by a marginal or new investment project under a given tax regime, including tax incentives. METR analysis is a powerful tool for evaluating the total impact of taxes on investment, as it accurately measures the extent to which taxes paid on an investment project affect the profitability, and therefore the desirability, of the venture.

Our analysis demonstrates that the current investment incentive program causes an inter-sectoral tax distortion of more than twice the amount that would occur in the absence of such investment incentives. The inter-sectoral tax distortion is measured by the dispersion of marginal effective tax rates across 13 business sectors and sub-sectors of the Jordanian economy.

Of course, without any investment incentives, the overall cost of capital to investors would be higher, due to the loss of the tax benefits that the current program offers to selective sectors of the economy. However, by providing alternative tax incentives that are less selective and directly linked to capital investment, such as an import duty exemption and a 20-percent initial allowance for investment in machinery and equipment (M&E) that would be available to all businesses, the inter-sectoral tax distortion be drastically reduced (from the current 4.8 percent to 1.8 percent), and the overall tax cost

to business can be reduced to a level (13.5 percent) lower than that associated with the current investment incentive program (14.2 percent). (See Chapter 3 for further information.)

Further analysis compares Jordan to its major competitors for foreign investment within the region, namely Egypt, Israel, Tunisia, and United Arab Emirates (UAE)/Dubai. This comparison reveals that Jordan's marginal effective tax rate on foreign investment is the second-lowest in this group for manufacturing (when measured by Zone A incentives) and the third highest in the services sector (excluding hotels and hospitals).

Jordan's wide gap in METR on foreign capital investment between the manufacturing and service sectors (17 percentage points) is second only to UAE/Dubai (26 percentage points) and indicates a significant sectoral tax distortion, which discourages foreign investment. As a result, with all else being equal and considering only taxation, foreign investors would have much less interest in Jordan's service sector, including high-technology, than in its manufacturing industry, which undermines efforts to modernize the economy.

By way of further comparison, Jordan's METR gap between manufacturing and service sectors (17 percentage points) is more than four times the gap in Ireland (4 percentage points), which has demonstrated exceptional success in attracting foreign investment and promoting rapid economic growth with a flat tax rate (currently 12.5 percent) and no selective tax incentives. Again, it is clear that the introduction of more even-handed tax incentives that are directly linked to capital investment would enable Jordan not only to retain its current tax advantage in manufacturing, but also to become the lowest-taxed country in services among its key regional competitors for foreign direct investment (FDI). Furthermore, its METR gap between manufacturing and service sectors would drop to a level close to that of Ireland. (See Chapter 4 for further information.)

Therefore, to achieve the efficiency, simplicity, and fairness in taxation that are espoused by *Jordan Vision 2020* as goals of the tax system and to follow international best practices, Jordan's currently cumbersome and inefficient investment incentives program should be replaced by a simpler and more efficient program that is directly linked to capital investment. Instead of following past thinking and continuing to design discretionary investment incentives, this study suggests that Jordan adopt an investment incentive program that is available to all business sectors, in all geographic locations, and at any stage of a firm's life. The only condition for qualifying for this investment incentive program would be that of investing in Jordan's economy, with no pre-approval whatsoever.

The following four recommendations seek to eliminate the tax distortions of current investment incentives, maintain Jordan's tax competitiveness in the region, remove unnecessary administrative and compliance costs, and improve the government's capacity to generate revenue. They are also consistent with the anticipated, comprehensive tax reform that will lead to a fully-modernized tax system in Jordan. (See Chapters 5 and 6 for further information.)

Recommendation One: No longer grant the income tax exemptions and reductions specified for new investment projects under the current investment incentive program.

While this resolution applies to all new investments, two options should be made available to those firms that have been granted incentives under the current incentive program. First, they may continue receiving their current incentives until their expiry date. In this way, incentives granted before the implementation of the new program are honored or "grandfathered," in order to fulfill legal commitments made in the past by government. Second, they may opt to receive the new incentives, which are outlined in Recommendations 2-4.

Recommendation Two: Expand the import duty exemption for fixed capital assets from the selected sectors that are favored by the current program to all business sectors.

This recommendation applies to all capital inputs, mainly M&E including spare parts and furniture, imported by investors for business use.

This exemption should be implemented alongside the general reduction in import duty that was initiated in 1997 as part of the "Law for Unifying Fees and Taxes Levied upon Imported Goods and Re-exported Goods."

Furthermore, this recommendation is in line with the *Jordan Vision 2020* recommendation that the "responsibility for qualifying and monitoring the customs and tariff waivers granted to investors" be transferred "from the Investment Promotion Corporation (Jordan Investment Board) to the Customs Department, where it more properly belongs."

This recommendation will not only reduce and ultimately eliminate import duties on capital goods, but will also help to modernize administrative procedures at Customs. A guideline on how to identify capital goods imported for business use should be provided by the Ministry of Industry & Trade.

Recommendation Three: Provide a 20-percent investment allowance for capital invested in M&E (including furniture) used for any business purpose.

This proposed initial investment allowance would be offered during the year when capital is invested. Such an investment allowance would be provided in addition to the annual depreciation allowance, although the cost of capital for annual depreciation would also be reduced by the investment allowance. It should also be made possible for any unclaimed investment allowance during the investment year to be carried forward for ten years.

This investment allowance for M&E, if adopted, should be provided to all investors in all economic sectors with no conditions whatsoever. Administration of this provision should be the responsibility of the Income Tax Department as a part of processing annual tax returns, without any pre-approval.

Recommendation Four: Provide an expense election for a limited amount of capital investment on an annual basis to support the growth of small- and medium-sized enterprises.

Small- and medium-sized enterprises (SME) usually have very limited access to funding for capital investment, and the size of their annual capital investment tends to be small. The growth of SMEs, however, is considered critical to more rapid economic growth in the economy as a whole.

Under this proposed expense election for capital investment, SMEs could choose to write off their annual capital investment immediately, up to the maximum amount (e.g., JD10,000), rather than relying on the conventional depreciation allowance. Any unclaimed balance of this maximum amount arising from inadequate operating profits should also be included in the base against which annual depreciation allowance can be claimed in the future. This incentive will provide SMEs with a cushion of cash flow during their startup years, which may be vital to their survival.

If adopted, this measure should be administered by the Income Tax Department as a part of processing annual tax returns, without any pre-approval. The Ministry of Industry & Trade and the Ministry of Finance should jointly create guidelines on the definition of an SME, as well as the maximum amount of capital investment allowed to be expensed under this provision.

We conducted revenue simulations for the above recommendations, based on data for 2001. An annual growth rate of 4.5 percent, which was the annual average in Jordan from 1998 to 2003, was also used in generating our projected revenue estimate for a five-year term. Our revenue simulations demonstrate that the net revenue impact during the base year, when all the proposed changes are first adopted, would be positive, but small. However, since capital investment will grow once investors take advantage of new incentives as they become available across the economy, the collection of company income tax can be expected to grow steadily on an annual basis. This in turn should also increase Jordan's revenue from the general sales tax (GST).[1]

[1] Sophisticated data (e.g., input-output accounts) and an econometric model (e.g., computable general equilibrium model) are required to estimate the revenue impact of sales tax growth accurately. Since neither was available at the time of this study, these estimates could not be made.

In summary, restructuring Jordan's currently cumbersome investment incentive scheme should be seen as the very first step towards creating a more desirable tax environment for capital investment in Jordan. While the complexity and inefficiency of the current tax system is not unusual in the region, Jordan can take the lead in reforming its tax system and will reap significant benefits accordingly.

It should be noted, however, that tax reform is an ambitious undertaking, which encompasses far more than this report can suggest. In particular, it requires a comprehensive review of both tax structure and tax administration. (See Annex 12 for further information.)

CHAPTER 1: INTRODUCTION

1.1 Objective

The primary objective of this report is to assist Jordan's Minister of Industry & Trade and Minister of Finance in the creation of a new program of investment incentives, according to international best practice, that can be used as the basis for regulations to support "The Investment Law of 2003" (hereafter The Investment Law).[2]

We have not been requested to propose changes to the current tax structure under which the existing investment incentive program was formulated. In our opinion, however, the reformulation of incentives under The Investment Law should be undertaken as an integral part of the comprehensive tax reform endorsed by the participants in the *Jordan Vision 2020* development program, who consider that "efficiency, fairness, transparency, and even-handed application should be hallmarks of Jordan's tax system."

1.2 Background

Historically, taxes were introduced to satisfy government's need for revenue. While other motives for taxation emerged as economies became more complex, such as the protection of local industries, income redistribution, industrial promotion, and environmental protection, the primary purpose of taxation is still that of collecting revenue to finance government services. These services, which range from enforcing law and order to investing in infrastructure, are vital to national economic development. If there were no need to fund these services, then there would be no need for taxes. In fact, a few of Jordan's resource-rich neighbors, such as Bahrain, UAE, and Kuwait, have not had to introduce general tax regimes. However, the natural windfalls enjoyed by these countries are rare and do not last forever. Consequently, taxes are and will remain the major and lasting source of government financing, and their ability to add value to the economy should be protected from erosion arising from arbitrariness in government policies, which includes the structure of investment incentives.

A traditional rationale for investment incentives is to encourage capital investment in areas that are inadequately served by markets. The designers of tax incentives around the world have believed they can induce investors to follow directions favored by the government, which in turn are assumed to ensure "wider benefits" for the overall economy.

Unfortunately, the directions favored by government have often been arbitrarily defined in terms of capital allocation by industry, or by type of investor, or by location, or by size of investment, or some combination of these criteria. For example, in many economies, tax incentives have been used to implement industrial policy, and were given first to the mining industry, then to manufacturing, then tourism, and then information technology, and so on.

Since governments rarely foresee economic structural change and are not able to pick the "winners" that will be chosen by the market ahead of time, existing industry-specific incentives often become an obstacle to fostering infant industries.

As for promoting regional development, no tax incentive in the world has ever attracted investors to areas where no fundamental conditions for profitability exist, such as the availability of natural resources, skilled workers, adequate infrastructure, or even population density to support markets. As such, tax incentives that were targeted to regional development have generally failed.[3]

[2] See Annex 2 for the Scope of Work of this consultancy.

[3] As stated in Shankar and Shah (2003), "regional development policies have failed in almost all countries–federal and unitary alike–to reduce regional inequalities."

Furthermore, regardless of how carefully these tax incentives are targeted, their immediate fiscal impact has always been to reduce tax revenue directly or indirectly by narrowing the tax base. When this revenue loss cannot be offset by the trickle-down or spillover effect expected from an "induced" capital investment, government must raise revenue elsewhere or cut expenditures, both of which can harm the economy without any beneficial offset. Failing tax incentives therefore need to be abandoned or redesigned.

As indicated, profit is the ultimate driving force for any investment decision in a market economy. Taxation is only one of the many factors that affect such capital allocation. The most important factors that motivate a profit-driven investment decision, as broadly recognized around the world, are the size of the market, economic stability, market-friendly institutional settings, adequate infrastructure, the availability of a trained labor force and natural resources.

When the overall investment environment is unattractive to investors, tax compensation through incentives cannot effectively attract unwilling investors. Furthermore, tax incentives may not be an effective factor at all in attracting foreign investors from countries that tax repatriated profits, such as the U.S. and the U.K., while providing credit for foreign taxes paid. In such cases, the tax incentives given to foreign investors result in a lower tax credit for the investors at home, and therefore a pure revenue transfer from the government of the investors' host country to that of the investors' home country.[4]

Finally, the design of tax incentives has progressively changed over the past several decades. Tax holidays were originally popular as an incentive but are losing favor compared to more efficient forms of incentives that are directly linked to the actual amount of investment[5]. In fact, "a low tax rate accompanied by loss carry forwards for tax purposes and accelerated depreciation is considered to be a major element in an effective tax system and one that is highly attractive to foreign investors."[6]

Hong Kong (China) and Ireland both illustrate the benefits of simplified tax rates. Both economies are small and poor in natural resources, and both have adopted low flat company tax rates, of 17.5 percent in Hong Kong and 12.5 percent in Ireland, for all business sectors with no discretionary tax incentives. Both countries have excelled in attracting FDI. As measured by the ratio of FDI inflow to GDP from 1997 to 2001, Hong Kong at 20 percent and Ireland with 14 percent stand out as the second and fourth most successful countries in the world.[7]

Jordan Vision 2020 sums up the objectives universally supported as the basis for a sound tax structure: efficiency, fairness, and simplicity. Targeted tax incentives aimed at encouraging new capital investment complicate a tax system in general and, when they are provided on a highly selective basis, reduce the efficiency and fairness of a tax system. This means that the same principles desirable in designing the overall tax structure should also be applied in designing a tax incentive program. With less differentiation in treating different types of investors, both the tax structure and incentive program will be more efficient, simple, and fair.

[4] Our recent meeting with a potential investor from the United States provides a fresh example. When told about the difference in tax benefit between paying the regular income tax and enjoying the income tax reduction, he immediately expressed preference for paying the regular income tax rather than going through the application for the tax holiday provided under the current incentive program, since the latter would not bring him any effective tax benefit.

[5] Drawbacks of tax holidays have been extensively documented. Recent references include UNCTAD (2000, pp.17-20), FIAS (2003, p.5), and Mintz (2004, pp.10-11).

[6] See UNCTAD (2000).

[7] See Mintz (forthcoming).

1.3 Methodology

The rest of this report consists of five sections.

Chapter Two provides an overview of the historical evolution of Jordan's current tax incentive program, and evaluates its effectiveness in terms of its observable relationship with current trends in capital investment.

Chapter Three calculates "effective" tax rates to quantify the tax distortion caused by the current tax incentive program.

Chapter Four presents a cross-country comparison of Jordan's tax incentives for foreign capital investment of Jordan with Egypt, Israel, Tunisia, and UAE/Dubai. A comparison between Jordan and Ireland is also presented to deepen the analysis.

Based on these analyses, Chapter Five generates a set of options, which follow international best practices, for restructuring the tax incentive program in Jordan. Revenue simulations for each these options, based on the best data available, are also included.

Chapter Six concludes the study with recommendations for formulating a new program of investment incentives in Jordan, followed by recommendations for future study and reform of the overall tax structure.

CHAPTER 2: OVERVIEW OF CURRENT INCENTIVE PROGRAM

In order to provide the basis for a new program of investment incentives in Jordan, this section offers an overview of the formation and content of current investment incentives, followed by our evaluation of this program, based on both international and domestic results.

2.1 Incentives Context

Tax incentives for capital investment in Jordan were initially provided in the "The Free Zones Corporation Law of 1984." Subsequently, "The Jordan Industrial Estates Corporation Law of 1985" (JIECL 1985) introduced tax holidays similar to those offered by the Free Zones Corporation for industrial projects established within Jordan Industrial Estates Corporation (JIEC) industrial estates.

"The Investment Promotion Law of 1987" (IPL 1987) extended tax incentives to more projects based on the nature of their business and geographic location, with the latter being used as a criterion for establishing the level at which tax incentives would be offered. Eight years later, the "The Investment Promotion Law of 1995" (IPL 1995) followed the same principles, but took a major step in extending tax incentives to many more projects and make them effectively more generous to targeted sectors.

Most recently, the Aqaba Special Economic Zone (ASEZ) was established in 2002 to provide a liberalized, low-tax, duty-free business environment.

2.2 Current Incentive Program

A multi-layered tax incentive structure has evolved in Jordan over the past twenty years. Since Jordan's Free Zones Corporation and ASEZ are independent tax territories, they are not included in the current study. With this exclusion, we have exhaustively examined the major components of the existing program of investment incentives, as defined under IPL 1995 (and its amendments) and JIECL 1985.

General business taxation in Jordan consists of the following three major taxes.[8]

- Company income tax
- Import duty on capital goods
- Property tax

Company income tax is differentiated by sector. The most favored sectors, which include mining and metallurgy, industry, hotels, hospitals, transportation, construction, and electricity, are taxed at the lowest rate of 15 percent. Banks and other deposit-taking financial firms are taxed at the highest rate of 35 percent. Other sectors, which include trade, communications, and services (i.e., non-banking financial services; medical services, excluding hospitals; tourism, excluding hotels) are taxed at a median rate of 25 percent.

The import duty on most M&E is zero, except for those items that may be used for consumption, such as small power generators, automobiles, and furniture. In the latter case, the import duty ranges from 3 to 30 percent.

The property tax is levied at a rate of 15 percent of rental value, which is deductible for income tax purposes if the owner occupies the building. At present, the effective property tax rate can be very low for owner-occupied buildings, since the current guideline for assessing the rental value for such buildings is only 12.5 percent higher than it was in 1984, when property prices and rental values were fractions of today's levels. According to some manufacturers, the reality is that factory buildings hardly bear any significant property tax burden.

[8] See Annex 3 for a complete review of Jordan's business tax laws. Payroll-based social security contributions payable by employers are ignored here since no incentives are based on this payroll-based levy.

The Investment Promotion Law of 1995 (IPL 1995)

Under IPL 1995, investment projects in industrial production; agriculture; hotels rated above three stars; hospitals; maritime transport and railways (MTR); leisure and recreational compounds (LARC); convention and exhibition centers (CAEC); transportation and distribution of water, gas, and oil (TDWGO)[9]; and "any other sector or subsectors the Council of Ministers decide to add upon the Council's recommendations"[10] enjoy two major tax incentives: an import duty exemption[11] and an income tax reduction.

The import duty exemption is defined in Articles 6 and 8 of IPL 1995 with the following major characteristics.

- The fixed assets of the project shall be exempted from import duty for three years from the date of approval. This three-year period may be extended upon approval.
- Spare parts valued at 15 percent or less of fixed assets for the project within 10 years from the date of commencement of production in the project shall be exempted from import duty.
- Increased imports of fixed assets resulting from an expansion in capacity of 25 percent or more shall be exempted from import duty.
- An additional exemption for purchase of furniture and supplies by hotel and hospital projects is available every seven years for modernization and renewal.

For purposes of income tax reduction, the country is divided into three development zones – A, B, and C – which are weighted by geographic location and industry for investment priority. The income tax reduction for qualified projects is 25 percent in Zone A, 50 percent in Zone B, and 75 percent in Zone C for a period of ten years. The tax reduction is available for up to four additional years when production capacity increases by no less than 25 percent on an annual basis.

The Jordan Industrial Estates Corporation Law of 1985 (JIECL 1985)

Under JIECL 1985, any new industrial project within a JIEC industrial estate or any existing industrial project that relocates to JIEC industrial estate receives a two-year exemption from income tax and social services tax, as well as a permanent exemption from property taxes.[12] Moreover, after the two-year income tax holiday ends, these industrial projects may enjoy the 10-year reduction in company income tax that is provide for under IPL 1995.

2.3 Problems with Current Incentive Program

Jordan's current investment incentive program is too complicated and inefficient. It has been formulated on a highly selective basis in terms of sectors, regions, conditional exemptions, and lengths of period to qualify for certain tax incentives.

In this section, we identify and explain the three major problems with this program, based on a review of international best practice in this area and interviews with firms that currently enjoy investment incentives in Jordan.[13]

[9] According to IPL 1995, the formal description of this sector is "pipeline transportation and distribution services for water, gas, and petroleum derivatives as well as its exploitation."

[10] See IPL 1995, Article (3). The latest addition approved by the cabinet under this article includes flight academies and information technology incubators.

[11] The original wording for this incentive is as follows. "The fixed assets of the Project shall be exempted from *fees and taxes* provided that they are imported into the Kingdom within a period of three years from the date of the Committee's decision approving the lists of fixed assets of the Project." Imported fixed assets are currently subject to three levies: import duty, general sales tax, and a unified customs fee. Since the general sales tax is refundable by law and the unified customs fee cannot be exempted for any imported goods, the exemption from "fees and taxes" is considered in this study to be the import duty exemption. As discussed in Chapter Five, exempting imported goods from the general sales tax – a value-added tax in Jordan – is not right and hence should not be recommended.

[12] The social service tax is a 10-percent surtax on individual income tax payable. The exemption from the social service tax applies when the investment project is undertaken by individuals rather than companies.

[13] See Annex 4 for the questionnaire used for our firm interviews.

Tax Holidays can be Ineffective and Have a High Cost in Lost Revenue

The current multi-leveled income tax reduction for selective sectors categorized by development zones significantly worsens the tax distortions caused by the existing multi-leveled income tax rates. In addition, tax holidays are not necessarily attractive to large-scale, long-term capital investment, especially when compared with provisions for loss carry forward and accelerated depreciation allowances that are available to regular business taxpayers.

Table 2.1 presents a matrix of the current income tax rates applicable to various sectors in Jordan, broken down by to their eligibility for investment incentives.

Table 2.1: Applicable Income Tax Rates and Investment Incentives

Sector	Tax Rate Without Incentives or After Incentives Expire	Tax Rates in Incentive Zones					
		A	B	C	Industrial Estates		
Banks and Financial Companies, excluding Insurance	35%	N/A	N/A	N/A	N/A		
Industry including Mining and Manufacturing	15%	11.25% for 10 years	7.50% for 10 years	3.75% for 10 years	Zero for 2 years+		
					A	B	C
					11.25% for 10 yrs	7.50% for 10 yrs	3.75% for 10 yrs
Hotels and Hospitals	15%	11.25% for 10 years	7.50% for 10 years	3.75% for 10 years	N/A		
Maritime Transport & Railways (MTR)	15%	N/A	N/A	3.75% for 10 years	Zero for 2 years + 3.75% for 10 yrs		
Construction, Electricity & Gas, Transportation excluding MTR	15%	N/A	N/A	N/A	N/A		
Leisure and Recreational Compound (LARC)	25%	18.75% for 10+ years	N/A	N/A	N/A		
Conventions and Exhibition Centers (CAEC)	25%	18.75% for 10+ years	N/A	N/A	N/A		
Transporting & Distributing Water, Gas & Oil (TDWGO)	25%	Defined on a case-by-case basis			N/A		
Other sectors not listed above	25%	N/A	N/A	N/A	N/A		

Source: Income Tax Law of 1985 and IPL 1995 (and its amendments).
Notes: "Other sectors not listed above" include insurance, exchange companies and intermediation, communications, services, and commercial companies.

As Table 2.1 shows, at least 11 differentiated income tax treatments of business activities exist in Jordan. This is a complexity that is not seen in many other tax jurisdictions today. The most inefficient and inequitable aspect of this differentiation is that firms that are carrying on business in the same sector are treated very differently.

Extreme examples of this inefficiency and unfairness can be drawn from two comparisons. The first comparison is between hospitals and clinics, which provide competing medical services. Hospitals are taxed at the 15 percent income tax rate and enjoy both a tax reduction for the first 10 years and a conditional import duty exemption. By contrast, clinics are taxed at a higher 25 percent income tax rate and enjoy neither a tax reduction for the first 10 years nor an import duty exemption on non-zero-rated medical equipment.

The second comparison is between hotels and tourist transportation, which provide complementary services in the tourism industry. Hotels are advantaged in the same ways as hospitals, while tourist transportation is disadvantaged in the same ways as clinics. Favoring hotels and discriminating against tourist transportation is contradictory. Moreover, since only hotels above three stars are rewarded with tax incentives, the current investment incentive program may result in an unbalanced hotel structure in Jordan, with luxury hotels being overbuilt and quality hotels for average tourists undersupplied.

To curb possible excessive revenue losses under the current incentive program, the Jordanian tax authority has made several changes in recent years to prevent qualifying firms that enjoy investment incentives from double-dipping into the tax benefits embedded in the current tax structure. In particular, regular business taxpayers are able to either double up or postpone their annual tax depreciation, and may also carry forward their operating losses indefinitely. These regular tax benefits are denied to investors who enjoy the current investment incentives.[14]

As such, the regular tax benefits under the current tax structure – at least partially and sometimes more than completely – offset the tax benefits of the current incentive program. For example, if a pipeline investment project takes 10 years to become profitable, it will be able under the current tax structure without incentives to use the losses carried over from the first ten years to reduce taxable income from the eleventh year onward until past losses are completely written off. By contrast, under the current incentive program, the same infrastructure investment project will not benefit from the 10-year tax reduction and will have to start paying full income tax from the eleventh year when it becomes profitable and its tax holiday expires.

As such, except for the import duty exemption, the current incentive program is less beneficial to large-scale, long-term capital investors than it is to footloose, export-oriented investors. In fact, over 27 percent of the investment projects that have applied for incentives, applied only for import duty exemptions.

Conditions on Import Duty Exemption for Fixed Assets are Restrictive and Obsolete

Tariffs on international trade were originally intended for protective purposes rather than to generate revenue. Import duties have since become a critical source of revenue for many developing countries, due to the lack of an effective direct income tax and other indirect taxes.[15] However, import duties on capital goods that range from standard M&E to furniture used for offices and services are, in effect, a tax on investment. With an import duty as high as 30 percent on certain capital goods in Jordan, investment projects that need to use these capital goods can be significantly hampered.

[14] See “Regulation No. (5) for 2002,” Article (5) for the regulations on depreciation allowances. See “Income Tax Law of 1985” and its amendments, Article (10) C for provision on loss carry-over.
[15] See Wayne (1997).

As the world moves towards a barrier-free trading community, more and more countries have significantly reduced their import duties and eliminated them on a broad range of capital goods.[16] Furthermore, since Jordan implemented its value-added or general sales tax (GST) on imported goods in 1997, GST revenue has risen from zero to JD234 million by 2003, while the revenue from customs duties only decreased by JD40 million.[17]

Therefore, neither the international trend nor a domestic revenue shortfall can be used to justify the present highly selective and conditional import duty exemptions. Indeed, these narrowly applied incentives have become an obstacle to the technological progress and structural changes that are indispensable for economic modernization in Jordan. For example, the communications sector is not entitled to the import duty exemption so that this sector incurs a higher cost on its investment in imported capital goods, which implies relatively high infrastructure costs in Jordan compared to those in Jordan's competitor countries.

Not surprisingly, our interviews with firms reveal that the import duty exemption for capital goods is the investment incentive that is most desired, compared to other incentives. Further complaints about the limited period for such exemption and about the rigid conditions for exempting on-going capital investment from import duty are also common.

No "Free Lunch" – Tax Incentives Have to be Paid for

The narrowly defined sectoral coverage of Jordan's incentive program results in a loss in revenue that must be subsequently covered by public spending cuts or increased taxes elsewhere. Further, the discretionary character of the program has created an environment that encourages interest groups to demand more selective incentives, which in turn pressures government to provide these incentives at a significant fiscal cost.

Our interviews confirmed that local firms in different lines of business want different types of tax incentives, and that these demands often contradict each other. For example, while large hotels want reductions in sales taxes to promote tourist spending, some well-established manufacturers advocate replacing the income tax completely by the sales tax.

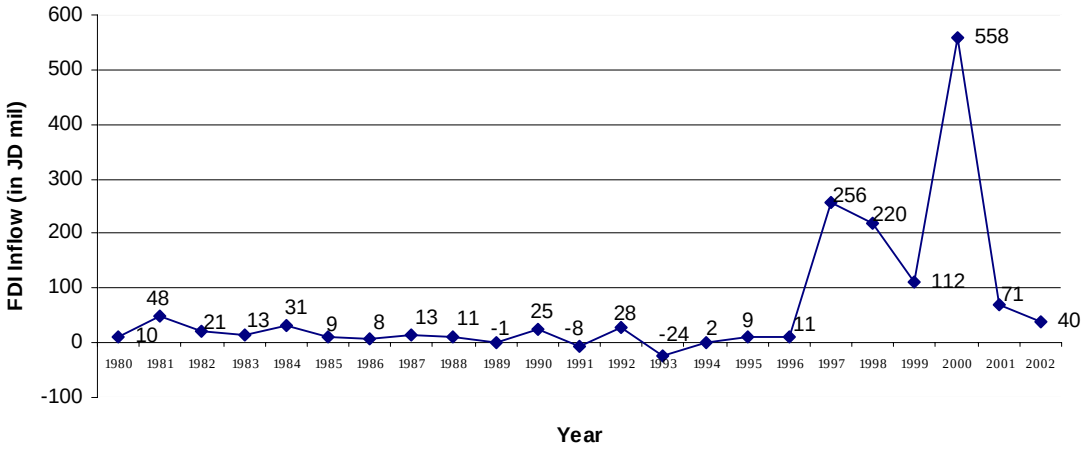
In fact, as more interest groups pressure for and get selective tax incentives, the government has to meet revenue targets by either levying new taxes or raising existing taxes. As a result, the erosion of the tax base caused by tax incentives for selective interest groups goes hand-in-hand with the increased need for more taxes in the economy as a whole.

2.4 Ineffectiveness of Current Incentive Program

Due to its complexity and inefficiency, Jordan's long history of investment incentives has not proved to be a significant factor in attracting capital investment in directions favored by the government. Figure 2.1 depicts the erratic trend in the inflow of total FDI to Jordan over the past 20 years.

[16] As can be seen in Chapter Four, countries that may be considered close competitors with Jordan for capital investment in the region levy much lower import tariffs on far fewer capital goods than Jordan. For example, Dubai (UAE) imposes no import duty on any goods that may be used for capital investment.
[17] Refer to Ministry of Finance, "Government Finance Bulletin," March 2004, Table 9.

Figure 2.1: FDI Inflow to Jordan, 1980–2002 (JD million)

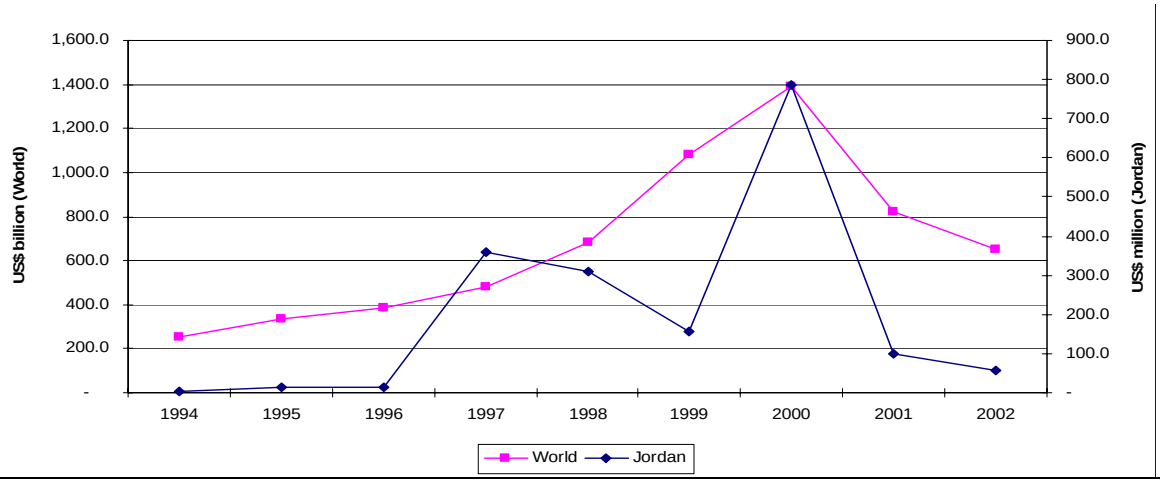


Source: International Monetary Fund, International Financial Statistics (http://imfStatistics.org)

Notes
The annual amount in Jordanian dinar was converted from the original U.S. dollar amount using the annual official exchange rate from 1980 to 2002.

While there at first would appear to be some momentum gained in 1997 and 2000 after the introduction of IPL 1995 and the initiation of Qualifying Industrial Zone (QIZ) operation in 1999, this data does not reveal any lasting benefit of tax incentives.[18] In fact, even the impressive FDI spike of JD558 million in 2000 cannot be primarily attributed to the first wave of QIZ establishments in that year. It was mainly a result of the privatization of the Jordan Telecommunications Company and the establishment of a joint venture between a Jordanian and an American company in potash production.[19] Excluding these two special events, FDI in 2000 would have been about JD127 million or only marginally higher than it was in 1999. In fact, during the entire period from 1994 to 2002, FDI inflows to most countries around the world peaked in or around year 2000, so the fact that FDI inflow to Jordan peaked in 2000 was largely an echo of this global trend, as illustrated by Figure 2.2.

Figure 2.2: FDI Inflow to Jordan and the World, 1994–2002 ($ million)



Source: International Monetary Fund, International Financial Statistics (http://imfStatistics.org)

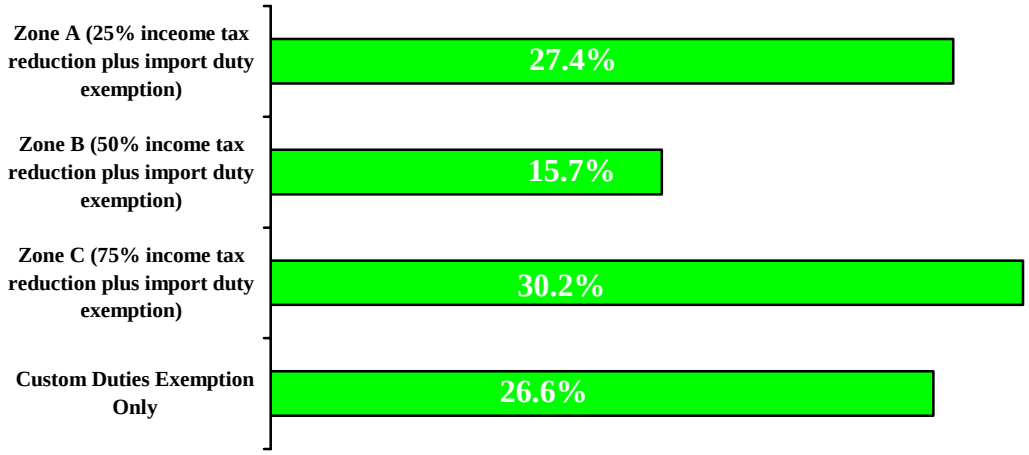
Notes
The annual amount in Jordanian dinar was converted from the original U.S. dollar amount using the annual official exchange rate from 1980 to 2002.

[18] See www.usembassy-amman.orj.jo for more information about the QIZ program.

[19] To privatize the Jordan Telecommunications Company, the Government of Jordan sold 40 percent of the company's shares, valued at JD360 million, to the France Telecom/Arab Bank consortium. For the Jordan-U.S. joint venture in potash business, the registered capital amounted to JD71 million.

Figure 2.3 breaks down total new investment projects entitled to tax incentives from mid-1996 to early 2004 by incentive zones.

Figure 2.3: Projects Benefiting from IPL 1995 by Region, 1996–2004 (%)



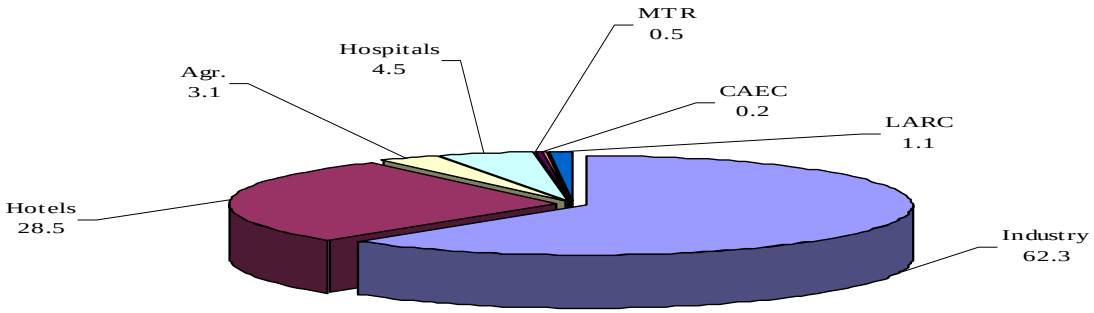
Source: Jordan Investment Board (JIB)

Notes
From 06 January 1996 to 02 March 2004. See Section 2.2 for details on investment incentives provided under IPL 1995.

Figure 2.3 clearly indicates that investors have not allocated their capital according to the degree of generosity of the tax incentives on offer. While Zone C – at 30 percent – appears to have attracted more capital investment than other zones, it is important to note that this share of investment is not proportional to its geographic share in the country, which is over 80 percent. It is also interesting to note that new investment projects obtaining only the import duty exemption without income tax reduction or exemption accounted for 27 percent of total new investment in the same period.

Figure 2.4, which breaks down new project applications by sectors, is even more revealing.

Figure 2.4: Projects Benefiting from IPL 1995 by Sector, 1996–2004 (%)



Source: JIB

Notes
From 06 January 1996 to 02 March 2004. See Section 2.2 for details on investment incentives provided under IPL 1995.

Both TDWGO and MTR investment projects benefit from the most favorable incentive package in terms of income tax reduction. Regardless of their physical location, any investment project in either of these sectors is entitled to the Zone C incentive package, which provides the most generous income tax reduction of 75 percent. By contrast, LARC investment projects are entitled to the less favorable Zone A incentive package, which provides the least generous income tax reduction of 25 percent.

Figure 2.4 clearly demonstrates, however, that there has been no investment in TDWGO and that the investment in MTR accounts for less than 50 percent of that in LARC despite the more favorable incentives. The reason for this discrepancy is that LARC projects are obviously more profitable and

require a much shorter period for investors to recover capital investment costs than MTR and TDWGO projects. In fact, transportation, including MTR and TDWGO is an area which often suffers "market failure" and hence requires direct government funding for investment.

In summary, the current investment incentive program is overly complicated and inefficient. Hence, it needs to be reformulated to encourage overall investment in Jordan. The following section will quantify how the current incentive program has increased the tax distortion on capital investment in Jordan.

CHAPTER 3: DISTORTING EFFECT OF CURRENT INCENTIVE PROGRAM

To quantify the distorting effect of the Jordan's current incentive program on capital investment, we make use of METR analysis. In this section, we shall first explain the concept of METR analysis and then present our estimate of effective tax rates on capital corresponding to the investment incentive program in Jordan.

3.1: Concept of Marginal Effective Tax Rate Analysis (METR)[20]

The way to judge how provisions in the tax system affect investment is to determine how much tax is paid by a firm on a marginal or incrementally profitable investment. After all, a firm will invest until the return it receives is equal to its financial cost of capital.

The marginal effective tax rate can be viewed conceptually as a summary measure that quantifies the overall cumulative tax burden that is placed on these new or incremental investments. It incorporates the effects not only of statutory tax rates and related tax treatments (e.g., tax depreciation, tax credits, tax deductibility, tax holidays), but also of various economic factors interacting with these tax treatments (e.g., financial costs, the inflation rate, the structure of investment). Due to this interaction between statutory tax provisions and actual economic and industrial conditions, effective tax rates can vary by industry, even under the same tax regime.[21]

Put another way, the calculation of METR is based on the assumption of profit maximization. Profit-maximizing firms base their investment decisions on the present value of foreseeable incremental net revenue. Taxes reduce the portion of the profits accruing to the investor, while tax allowances and incentives mitigate such a reduction in accrued profits. METR is the net amount of taxes paid as a percentage of income earned from an investment project on an annualized basis. For profit-maximizing firms, the rate of return on capital, net of economic depreciation, must be equal to the financing cost of capital, adjusted for taxes. The size of this adjustment for taxes on a new investment is the marginal effective tax rate on capital. For example, if the gross-of-tax rate of return to a new capital investment is 20 per cent and the net-of-tax rate of return is 10 per cent, then the marginal effective tax rate on capital is 50 percent.

Also note that the analysis of marginal effective tax rates provided in this study deals only with "profitable" firms. "Profitable" refers to those firms that have taxable income and will pay income tax if not granted a tax holiday. This assumption is important because a tax holiday has no value to an unprofitable firm, which does not have to pay income taxes anyway.

3.2: Effective Tax Rates on Capital in Jordan

Our estimate of effective tax rates on capital incorporates company income tax, import duty, property tax, property transfer tax, and taxes on financial investments.[22] The estimates are made for all sectors except banking and vary by category of incentives. This is to say, our estimates cover the following 13 sectors and sub-sectors.

- Mining and quarrying
- Manufacturing
- Construction
- Public utilities
- Trade
- MTR

[20] See Annex 5 for a detailed, technical description of METR analysis.

[21] See Annex 5 for information regarding the impact of non-tax factors on marginal effective tax rate.

[22] By assuming that investors are owners of their business buildings, we use an "arbitraged" property tax rate of five percent rather than the standard 15 percent for our METR estimate for Jordan. This is because, in reality, owner-occupied buildings are taxed much less than rental buildings.

- Non-MTR transportation
- Communications
- Hospitals and hotels
- LARC
- CAEC
- TDWGO
- All other services

These sectors and sub-sectors fall into the following different incentive categories.

- No incentives
- Zone A
- Zone B
- Zone C

We give special consideration to manufacturing projects located in JIEC industrial estates, since they enjoy additional incentives under JIECL 1985, and exporting projects (e.g., QIZ manufacturers), since they currently enjoy a full exemption for export revenue from income and social services taxes under a special arrangement made between Jordan and the World Trade Organization.[23]

We exclude the banking sector, which is the highest taxed sector and accounts for little more than two percent of GDP in Jordan, from our METR analysis since it is irrelevant to the investment incentive program.

Table 3.1 presents our estimate of effective tax rates by sector and by incentive category. We also estimate the inter-sectoral distortion caused by the current investment incentive program, measured as the dispersion of marginal effective tax rates among all the sectors covered in this study.[24]

Table 3.1: METR for Business Sectors by Sector and Type of Incentive (%)

Sector	Zone A	Zone B	Zone C	No Incentives
Mining and quarrying	9.3	7.1	5.0	
Manufacturing				
JIEC industrial estates	6.0	4.9	3.8	
Exporting firms/QIZs		8.4	8.4	
Others	10.7	8.7	6.8	
Construction				18.6
Public utility				
Excluding TDWGO				24.5
TDWGO	16.6	12.6	8.7	
Trade				23.6
Transportation				
Excluding MTR				22.3
MTR			6.7	
Communications				27.1
Services				
Hospitals and hotels	15.8	13.7	11.6	
LARC	20.5			
CAEC	20.5			
All others				24.3
Average				14.2
Distortion (points)				4.8

Notes
MTR all classified as in Zone C, LARC all classified as in Zone A, and CAEC all classified as in Zone A.
"Services" includes financial services, except banks. As explained in Section 3.2, the banking sector is excluded from our study as it is irrelevant to the investment incentive program.

[23] This arrangement remains in force until 2007, after which time it must be renewed annually.
[24] The inter-sectoral METR dispersion coefficient is the weighted average of the standard deviations of METR by type of assets across industry. See Annex 5 for the formula used to estimate this measure.

Five main observations may be drawn from this data displayed in this table.

High Taxes on Sectors not Qualifying for Incentives

Sectors that do not qualify for tax incentives or the "non-favored" sectors of the economy are taxed at a much higher rate than those that are entitled to tax incentives. Besides the burden of the income tax, the import duty on M&E is a major reason for the high METR in these sectors. To demonstrate this point further, Table 3.2 presents the same estimate as Table 3.1, but excludes import duty on M&E for all sectors regardless of their incentive status.

Table 3.2: Simulated METR with Universal Import Duty Exemption (%)

Sector	Zone A	Zone B	Zone C	No Incentives
Mining and quarrying	9.3	7.1	5.0	
Manufacturing				
Industrial estates	6.0	4.9	3.8	
Exporting firms/QIZs		8.4	8.4	
Others	10.7	8.7	6.8	
Construction				13.2
Public utility				
Excluding TDWGO				7.1
TDWGO	16.6	12.6	8.7	
Trade				16.3
Transportation				
Excluding MTR				9.1
MTR			6.7	
Communications				16.5
Services				
Hospitals and hotels	15.8	13.7	11.6	
LARC	20.5			
CAEC	20.5			
All others				19.7
Average				10.5
Distortion (points)				2.7

Notes
MTR all classified as in Zone C, LARC all classified as in Zone A, and CAEC all classified as in Zone A.
"Services" includes financial services, except banks. As explained in Section 3.2, the banking sector is excluded from our study as it is irrelevant to the investment incentive program.

A comparison between Tables 3.1 and 3.2 shows that eliminating the import duty on M&E payable by the non-favored sectors would substantially lower their effective tax rates. As a result, the inter-sectoral tax distortion would be reduced from 4.8 percent to 2.7 percent, which is a decrease of over 40 percent.

Alternatively, if no investment incentive were given to the favored sectors, the METR for sectors entitled to the current incentive program would be higher, but the inter-sectoral tax distortion would be reduced even more dramatically to 2.1 percent. (See Base Case in Table 3.3 for further information.)

Important Sectors for a Modern Economy are too Highly Taxed

Among non-favored industries, communications is the most highly taxed sector in Jordan at 25 percent, followed by services at 23 percent, trade at 22 percent, and public utilities at 21 percent.[25]

There are two main explanations for this ranking. First, the income tax rate applicable to these sectors is 25 percent, the highest rate among all sectors covered in our analysis. Second, most capital invested in these sectors is in buildings and M&E, which are the highest-taxed assets.[26] Buildings are subject to property tax and the comparatively high property transfer tax. Furthermore, some M&E

[25] The tax rate for services excludes the sector's favored sub-sectors.
[26] See Annex 6, Table A.1 for further information.

used by communications and other non-favored sectors is liable for import duty, with an effective duty rate of almost 7 percent based on 2003 customs statistics.

As the data in Table 3.2 demonstrates, solely eliminating the import duty on M&E would reduce the effective tax rate on the communications sector by almost 9 percentage points. Other sectors would also experience benefits from this measure, ranging from 4 percentage points for non-favored services sectors to 14 percentage points for the public utility sector.

Some Incentives are not Effective

Among favored sectors, manufacturing projects located in JIEC industrial estates appear to enjoy the lowest effective tax rate. These projects are not only granted an additional two years of income tax exemption over those in other locations, but they also enjoy a permanent exemption from property taxes. Without the permanent property tax exemption, the METR on all manufacturing projects in JIEC industrial estates would be above 10 percent and hence higher than the METR for all other manufacturing projects.

By not paying income tax during the first few years of their project lives, investment projects in JIEC industrial estates also lose the benefit from income tax allowances such as deductibility for interest expense (unadjusted for inflation) and the annual depreciation allowance. When the loss of such tax benefits exceeds the gain from the full income tax exemption, the METR for these more favored projects can be higher than those for less favored projects.

Increasing Incentives may not Provide Benefits to Investments in Some Cases

More generous income tax reductions do not necessarily provide greater benefits to investors. This can be seen from a comparison between two manufacturing projects located in Zone C: one inside a QIZ and the other outside. The effective tax rate for the former is 8 percent and for the latter 7 percent, even though the former is fully exempted from income tax and the latter is subject to an income tax rate of 3.75 percent (or 25 percent of 15 percent).

This comparison further illustrates the counterintuitive finding that paying no income tax may not be as beneficial as paying some income tax. This finding is not strange at all to some favored manufacturing firms. In fact, during our firm interviews, some interviewees stated clearly that a longer period of partial income tax exemption is preferred to a shorter period of full income tax exemption.

In this way, some firms located in the JIEC industrial estates have managed to reverse the legal sequence for enjoying JIEC incentives and IPL 1995 incentives. Instead of following the legal sequence of enjoying the two-year full tax exemption allowed under JIECL 1985 before using the 10-year partial tax exemption allowed under IPL 1995, these firms have managed to take up the 10-year partial tax exemption before using the two-year full tax exemption. By doing so, these firms maximized the benefit from the two incentives by writing off losses during the first ten years when they were paying some income tax and avoiding paying any income taxes after the tenth year when they became more profitable.

Inequitable Taxes on Similar and Complementary Sectors

As discussed in Chapter Two, the current incentive program treats many sectors having similar or complementary business interests very differently. For example, the effective tax rate on hospitals is 16 percent in Zone A. This is 8 percentage points below the 24-percent rate imposed on clinics, even when they are located in the most favored geographic Zone C.

In other words, medical services provided by a clinic in a rural area incur a higher tax cost than the same services provided by a hospital located in Amman. This is because clinics do not qualify for any investment incentive and therefore have to pay more income tax than hospitals, in addition to paying import duty on medical equipment that is duty-free to hospitals.

3.3: Simulation for Alleviating Tax Distortions and for Alternative Incentives

Based on the above observations, we shall now provide a set of simulations that illustrate measures that would alleviate tax distortions caused by the current investment incentive program and furnish alternative incentives that would benefit all business sectors and hence lower the tax cost in the overall economy. The revenue impact of alternative incentives is presented in Chapter Five.

Table 3.3: Simulated METR with Alternative Incentives (%)

Industry	Current Case**			No Incentives	Base Case	Case 1	Case 2	Case 3
	Zone A	Zone B	Zone C					
Mining	9.3	7.1	5.0		22.0	9.1	7.9	18.9
Manufacturing	6.0-10.7	4.9-8.7	3.8-8.4		21.8	10.5	9.4	19.0
Construction				17.5	17.5	13.2	12.8	20.6
Public utility				21.4	21.4	7.1	5.6	17.2
Trade				22.2	22.2	16.3	15.2	21.6
Transportation				19.9	19.9	9.1	8.0	19.3
Communications				25.1	25.1	16.5	15.0	24.2
Hotel/Hospital	15.8	13.7	11.6	NA	20.5	16.6	16.3	20.3
Other Services				23.4	23.4	19.7	19.2	23.1
Average				14.2	21.5	14.4	13.5	18.4
Distortion (points)				4.8	2.1	1.9	1.8	2.1

Key

Current Case	Under the current investment incentive program available to selective sectors
Base Case	Exclude all incentives
Case 1	Exempt import duty on M&E for all sectors and eliminate income tax reduction by incentive zone
Case 2	Apply Case 1, plus 20% investment allowance
Case 3	Provide 20% investment allowance without exempting import duty on M&E for all sectors

Notes

As explained in Section 3.2, the banking sector is excluded from our study as it is irrelevant to the investment incentive program.

See Table 3.1 for the marginal effective tax rate on capital investment in those sub-sectors that are currently entitled to investment incentives under the current program.

Base Case

No current investment incentives. This scenario serves as our starting point for analyzing and comparing alternative incentives.

By excluding all types of investment incentives, it is not surprising that METR for industries favored under the current scheme, including mining, manufacturing, hotels and hospitals, MTR, LARC, CAEC, and TDWGO, would be much higher than the actual rates shown in Table 2.1.

As a result, the weighted average of effective tax rates across all sectors would be seven percentage points higher: 21.5 percent, instead of 14.2 percent. Since all the sectors are treated "equally" in the sense that no one gets a special incentive, however, the inter-sectoral tax distortion would be reduced from the current 4.8 percent to 2.1 percent.

Case 1

Import duty exemption for M&E (including spare parts) imported by all investment projects in any sector and any stage in their life. No income tax exemption by incentive zone.

By providing this unconditional import duty exemption for imported capital goods to all sectors, the effective tax rate for all sectors would be significantly lowered from the rates in the Base Case scenario. As a result, the weighted average of METR across sectors would be 14.4 percent, which is roughly the same as under the current investment incentive program rate of 14.2 percent, and the inter-sectoral tax distortion would be further reduced to 1.9 percent.

Case 2

An initial allowance of 20 percent is provided for investment in M&E for all investment projects.

This is an incentive that could be offered as an alternative to the income tax exemption provided by the current incentive program. Our simulation assumes it would be provided in addition to the unconditional import duty exemption for M&E.

This added incentive would further reduce the average METR across all sectors to 13.5 percent, almost 1 percentage point lower than that the 14.2 percent rate under the current incentive program. In addition, the inter-sectoral tax distortion would be reduced further to 1.8 percent.

Case 3

An initial investment allowance of 20 percent is provided for investment in M&E, without the unconditional import duty exemption for M&E.

The resultant average METR across all sectors is significantly higher than that shown in both Case 1 and Case 2. This simulation demonstrates the point that the major tax burden on capital investment arises from the import duty on M&E. It is therefore not surprising that our interviews revealed that the most desirable incentive from the point of view of investors is the unconditional import duty exemption for M&E.

Additional Simulations

The additional simulations shown in Table 3.4 have no policy implications in our study, and serve only to show how effectively a flat tax rate across all sectors can alleviate inter-sectoral tax distortion.

These additional simulations demonstrate that, if all sectors were taxed at an identical income tax rate of 15 percent, in addition to the import duty exemption presented in Case 1, the inter-sectoral tax distortion could be substantially reduced to below 1.3 percent or nearly three-fourths below the current rate of 4.8 percent.

Table 3.4: Simulated METR with Single Tax Rate (%)

Sector	Base Case	Case 1	Case 1A	Case 2	Case 2A
Mining	22.0	9.1	9.1	7.9	7.9
Manufacturing	21.8	10.5	10.5	9.4	9.4
Construction	18.6	13.2	13.2	12.8	12.8
Public utility	24.5	7.1	7.1	5.6	5.6
Trade	23.6	16.3	12.6	15.2	12.0
Transportation	22.3	9.1	9.1	8.0	8.0
Communications	27.1	16.5	14.8	15.0	13.9
Hotel/hospital	21.5	16.6	16.6	16.3	16.3
Other service	24.3	19.7	16.6	19.2	16.3
Average	23.2	14.4	12.9	13.5	12.1
Distortion (points)	2.2	1.9	1.27	1.8	1.2

Key

Base Case	Exclude all incentives
Case 1	Exempt import duty on M&E for all sectors and eliminates the income tax reduction by incentive zone
Case 1A	Apply 15% income tax to all sectors and exempt import duty on M&E for all sectors
Case 2	Apply Case 1, plus 20% investment allowance
Case 2A	Case 1A plus a 20% investment allowance

All of the above simulations show that the current incentive program can be restructured to provide a level playing field for all investors in addition to lowering the burden of taxes on the economy as a whole. Although these simulations imply that some sectors or sub-sectors may lose future tax privileges that are offered under the current incentive program, the overall improvement of the tax environment will more than offset these sectors' short-term loss and will ultimately benefit all sectors in the long run.

For example, while five-star hotels might lose the targeted tax advantage they currently enjoy, the economic growth stimulated by a more efficient and broadly-available incentive program is likely to bring more tourists to Jordan. This, in turn, would benefit the hotel business on a more sustainable basis over the long run than is possible with the current incentives.

CHAPTER 4: TAX IMPACT ON FOREIGN INVESTMENT BY COUNTRY

Many Jordanians are eager to know how their country's investment incentives compare with those in other countries, especially those within the region with which Jordan competes directly with to attract FDI, such as Egypt, Israel, Tunisia, and UAE/Dubai.

As manufacturing and services are the main outlets for FDI around the world, the question of a country's "competitiveness" in attracting foreign investment has always focused on the tax cost or benefit faced by these two sectors.

To evaluate Jordan's tax attractiveness to foreign investors, we have outlined the major features of tax structure and incentives in the aforementioned countries. (See Annex 7 for a more detailed description of each country's tax system.) We then provide a comparative METR analysis in each country as it affects the tax cost on foreign capital investment in manufacturing and service sectors.

We also include a simulation of the in Ireland, which is frequently as a model for developing countries in its tax regime, to deepen the basis for comparison.

4.1: Comparison of Jordan's Tax System to Other Countries

Table 4.1 summarizes and compares the major features of statutory provisions for business taxes and incentives in Jordan, Egypt, Israel, Tunisia, and UAE/Dubai. Ireland is also included.

As this table demonstrates, there is a great deal of similarity between Jordan's statutory tax and incentive provisions and those of its main competitors within the region for attracting foreign investment. While this might at first be seen as an indication that Jordan is already competitive, it in fact demonstrates that Jordan does not distinguish itself to foreign investors as a uniquely attractive destination. Therefore, Jordan's tax measures do not stand out, since many other countries in the region follow a similar approach.

Comparison of Tax Structure

With regard to tax structure, the similarities and differences of Jordan from these other nations are as follows.

- The income tax rate is multi-leveled in all countries but Israel. The highest rates are all at or exceed 35 percent.
- There are income- or revenue-based taxes other than the company income tax in some countries, including the university tax and vocational training tax in Jordan and several turnover-based taxes in Tunisia.
- All countries except Egypt have similar annual depreciation allowances of around 4 percent for buildings and 15 percent for M&E, including furniture.
- All countries except Egypt allow operating losses to be carried forward indefinitely, which lessens the appeal of tax holidays.
- All countries levy property tax based on rental value. Jordan's rate is around the median level of these nations, although the tax base in Jordan may differ significantly between owner-occupied buildings and those on the rental market, owing to Jordan's out of date property evaluation for owner-occupied buildings.
- Jordan levies the highest property transfer tax of these nations at 10 percent, instead of the 5 percent in most other countries.
- All countries except UAE have tariffs on some imported M&E, mostly equipment with uses in both production and consumption or spare parts. Among these countries, Jordan has the highest import duty (i.e., up to 30 percent versus 5 to 10 percent elsewhere) and fewer duty-

free items.[27] The estimated effective import duty paid by most business sectors on M&E in Jordan in 2003 is 6.7 percent, which is higher than the 5 percent flat statutory rate levied on selective items in other countries such as Egypt and Tunisia.[28]

Table 4.1: Business Tax Provisions Applicable to Manufacturing and Service Industries

Capital Taxes	Jordan	Egypt	Israel	Tunisia	UAE	Ireland
Company income tax rate (%)	15/25/35	34.0/42.0	36.0	20.0/35.0	0-55	12.5
Tax on other income or revenue	Yes	None	None	Yes	Yes	None
Tax depreciation rate*						
Buildings	2.0-4.0 SL	2.0 SL	2.0-8.0 SL	5 SL	4.0 SL	4.0 SL
Machinery						
Manufacturing	15.0 SL	15.0 SL	7.0-20.0 SL	10 SL	15.0 SL	15.0 SL
Service	17.5 SL	15.0 SL	6.0-20.0 SL	17.5 SL	15.0 SL	15.0 SL
Loss carry-forward	Indefinitely	5 years	Indefinitely	Indefinitely**	Indefinitely	Indefinitely
Withholding tax on dividends	None	10.0	25.0	None	None	20.0
Property tax (% of rental)	15.0	30.0-32.0	N/A	8.0-14.0	10.0	4.1
Property transfer tax (%)	10.0+	5.0	Up to 5.0	5.0	4.0	9.0
Import duty on M&E*** (%)	Up to 30.0	Up to 10.0	Mostly zero	Up to 5.0	0.0	Mostly zero
Tax Incentives						
Tax holidays (years)	10+	5/10/20	7/10	10+10	5	No
Accelerated depreciation allowance	Yes	Yes	Optional	Yes	Yes	Yes
Import duty exemption	Yes	Yes	Yes	Yes	Yes****	Yes

Notes

* As the classification of depreciable assets varies by country, please refer to the text discussion for details.

** For deferred depreciation in loss years only. Other operating losses may be carried forward for four years.

*** The import tariff shown in this table is adapted from Jordan's Ministry of Finance, Customs Department, "Jordanian customs tariff based on the Harmonized System."

**** According to the International Bureau of Fiscal Documentation (IBFD), as an investment incentive, all the capital goods imported to UAE are exempted from the import duty; according to information published at the official website of Jordan's Customs Department, import duty is zero on all goods imported to UAE. Despite the inconsistency, both sources indicate an effective zero import duty on M&E.

Comparison of Tax Incentives

With regard to tax incentives, all countries provide income tax reductions or full exemptions, as well as import duty exemptions for investment projects. Sectoral coverage of these incentives, however, varies from country to country.

Egypt

Egypt provides a full income tax exemption for qualified capital investment. The length of the tax holiday varies according to the number of employees, the location of the investment, and the type of business.

The major types of tax holidays that are most relevant for our comparisons are five and ten years in duration. The five-year tax holiday is available for *all* industrial and commercial projects that hire 50 or more employees and maintain proper accounting books. Projects located in new industrial zones, new urban communities, and remote areas are exempt from tax for 10 years from the beginning of their activities.

Egypt also allows a three-year exemption from stamp duty and provides an *unconditional* initial investment allowance (25 percent) for investment in M&E.

Israel

Israel provides alternative types of tax incentives for investment projects operating in its industrial, technological, and tourism sectors. An approved project may enjoy a reduced income tax rate of 25 percent for a period of seven years or double the annual depreciation allowance for the first five years after the depreciable assets are put in use.

[27] See Jordan's Harmonized System of Tariff Codes, which provides tariff rates in other Middle East countries (including the four competitor countries under our study) and is published by the Department of Customs at www.customs.gov.jo, for further information.

[28] See Annex 9 for the data and procedures used to arrive at this estimate.

Israel treats foreign investors more generously than its own domestic investors and directly links the incentive to the size of foreign ownership. Thus, an income tax rate of 10 percent is available for 10 years for projects with over 90-percent foreign ownership. In addition, income received by a foreign entity arising from an investment in an R&D-intensive Israeli company is totally exempt from tax.

Tunisia

Tunisia provides tax incentives based on the Tunisian Investment Code for investments in its industrial, service, and tourism sectors. The code *automatically* applies to both resident and non-resident investors with no prior approval required. The general tax incentive is an exemption from income tax for up to 35 percent of taxable income or profits, as long as investors follow regulations for accountancy, tax filing, paid-up capital, and so on. There are also special incentives for targeted business activities.

UAE/Dubai

UAE/Dubai provides a five-year income tax exemption along with other privileges for manufacturing (including processing operations) with certain restrictions. For example, projects with capital of AED250,000 or less and 10 or fewer employees, are not covered by this law. There is also a nationwide import duty exemption for business inputs.[29]

Despite some similarities, there are several features in the tax incentive programs offered by Jordan's competitor countries that deserve special attention. First, after it is approved, the duty exemption for plant and equipment, spare parts, and raw materials in UAE/Dubai is valid during the entire life of the project. No continued interaction with the approving authority is required.

Second, Tunisia's reduced income tax liability for a broad range of business sectors is provided as a general tax incentive, the only condition for which is practicing good company governance. A similar general incentive (i.e., a five-year tax holiday for all sectors) is also offered in Egypt, although firms hiring less than 50 employees are excluded.

Third, Israel offers a more straightforward support for fixed capital investment in the form of an accelerated depreciation allowance that can be adopted as an alternative to a tax reduction. This is similar to the accelerated depreciation allowance offered in Jordan for all companies that are not entitled to investment incentives.

These features reflect a progressive change in incentive programs in these countries towards providing functional tax incentives that are not restricted to specific industries, geographic locations, or limited periods of time.

4.2: Evaluation of Jordan's Tax Competitiveness Within the Region

We will again use METR analysis in this section to compare Jordan's tax competitiveness for foreign investment with the selected region competitors.

The principal foreign investors in Jordan are from other Arab countries, Europe, and North America, with the United States accounting for the largest share.[30] Accordingly, the United States has been chosen as the origin of a representative foreign investor for our analysis. (See Annex 8 for the major tax and non-tax parameters for U.S. investors used in our cross-country METR analysis.)

Income earned in a host country by a foreign investor may or may not be taxed in the investor's home country. There are two primary models, one best illustrated by the U.S. system and the other by the French system. In the case of U.S. investment, income earned in Jordan will be taxed in the U.S. with

[29] This information is published by IBFD. According to Jordan's Customs Department (www.customs.gov.jo), the import duty is zero for all the goods imported in the UAE.

[30] According to the Jordan Investment Board, during the period 1997-2002, the U.S. share in total value of total foreign investment projects ranged from 20 percent (1999) to 48 percent (2002), except for 2001 when it was 5 percent.

a credit for taxes paid in Jordan.[31] In the case of French investment, income earned in Jordan is "spared" and not considered taxable in France.

Table 4.2 provides an effective tax rate comparison based on the example of a U.S. company investing in either the manufacturing or service sectors of Jordan, Egypt, Israel, Tunisia, and UAE/Dubai.

On the one hand, since almost 60 percent of manufacturing investment in Jordan is located in Zone A, the incentive package associated with Zone A is used as a representative incentive package for Jordan's manufacturing industry.

On the other hand, since over 90 percent of the firms in the service sector in Jordan do not benefit from any incentives under IPL 1995, we estimate METR for Jordan's services sector based on the regular tax structure, which allows doubling up the annual depreciation for regular taxpaying firms. In addition, METR on foreign capital invested in Jordan's hospitals and hotels with three or more stars is also estimated as a case of special interest.

For countries other than Jordan, METR is estimated for incentive packages that are available to most foreign investors in the manufacturing and service sectors. The following is a list of the types of specific incentives included in this comparison.

For manufacturing industries

- Jordan: An investment project located in Zone A (i.e., an income tax rate of 11.25 percent for 10 years) and an import duty exemption
- Egypt: An investment project located in a new industrial zone, with a 10-year income tax exemption and an import duty exemption
- Israel: A 10-year reduced income tax rate of 10 percent for an investment project having over 90-percent foreign ownership, with no import duty applied
- Tunisia: A 35-percent reduction in taxable income, as well as a zero-duty rate on imported capital goods
- UAE/Dubai: A five-year tax exemption for industrial sectors and no import duty on M&E.

For service sector firms

- Jordan: A general services sector firm subject to a 25-percent income tax rate with no investment incentives, except that firms can double the annual depreciation allowance for tax purposes. Hotels and hospitals in Zone A (i.e., an income tax rate of 11.25 percent for 10 years) with an import duty exemption.
- Egypt: A five-year full tax exemption available for all industrial and commercial projects with import duty exemptions on inputs
- Israel: A 10-year reduced income tax rate of 10 percent for investment projects having over 90-percent foreign ownership, with no import duty applied
- Tunisia: A 35-percent reduction in taxable income, as well as a zero-duty rate on imported capital goods
- UAE/Dubai: General services sectors have no incentive tax provisions, but imported M&E are duty-free

[31] Owing to the implementation of the post-1988 interest allocation rule, the taxation of foreign income in the U.S. can be slightly more complicated than that mentioned in the text. See Annex 5 for a more detailed, technical discussion on how foreign investment income is taxed in the United States.

Table 4.2: Cross-country Comparison of METR on FDI (%)

Manufacturing						
Jordan			Egypt	Israel	Tunisia	UAE/Dubai
Current Case	Case 1	Case 2	10-yr tax holiday	10-year/10% CIT	General incentive	5-yr tax holiday
7.7	11.6	10.6	13.8	12.4	15.8	6.7
Services						
Jordan			Egypt	Israel	Tunisia	UAE/Dubai
Current Case	Case 1	Case 2	5-yr tax holiday	10-year/10 CIT	General incentive	Non-incentives
24.3 /21.9*	17.9	17.3	29.5	19.0	19.1	32.8
Sectoral Gap in METR between Manufacturing and Services Sector						
Jordan			Egypt	Israel	Tunisia	UAE/Dubai
Current Case	Case 1	Case 2				
16.7/14.2*	6.3	6.7	15.8	6.6	3.2	26.1

Key

Current Case	Under the current investment incentive program available to selective sectors
Case 1	Exempt import duty on M&E for all sectors and eliminate the income tax reduction by incentive zone
Case 2	Apply Case 1, plus 20% investment allowance

Notes

*The lower number is for hospitals and hotels with three or more stars.

Table 4.2 demonstrates that foreign investors in Jordan enjoy the second-lowest tax cost on manufacturing (8 percent), measured by METR, but incur the third-highest effective tax rate in the services sector (24 percent), with the exception of hotels and hospitals (22 percent).

Among other countries, UAE/Dubai appears to have the lowest METR on manufacturing, primarily due to its low property transfer tax rate (4 percent versus less than the 5 percent in other countries and 10 percent in Jordan) combined with a five-year full-tax exemption.

The higher METR for manufacturing in other countries stems either from comparatively high property tax (e.g., 30 percent on rental value in Egypt) or a relatively high income tax rate after the tax reduction period (e.g., 36 percent in Israel and 35 percent in Tunisia).

Interestingly, the highest METR for the services sector appears to be in UAE/Dubai (33 percent), and the second highest in Egypt (30 percent). UAE/Dubai does not provide any tax incentives for firms in the non-banking services sector, and Egypt's high property tax is once again a main contributor to its high METR.[32]

Israel and Tunisia enjoy the lowest overall METR (19 percent) because both countries provide the same incentives to the services sector as to manufacturing industry.

The METR for the service sector is generally higher than that for manufacturing industry in all countries because investment in the service sector requires more capital in buildings compared to other types of assets. The higher METR on buildings associated with the property tax and property transfer tax contribute to the higher METR for services sector.

As both Tunisia and Israel provide even-handed general incentives to all business sectors, the gaps in METR between the manufacturing and services sectors in these two countries (3 and 7 percentage points, respectively) are much narrower than the gaps in Jordan (17 percentage points), UAE/Dubai (26 percentage points), and Egypt (16 percentage points).

A simulation for alternative incentives in Jordan, as performed previously in Chapter Three for our domestic cross-sector comparison, has been repeated in this case for foreign investors. By assuming no income tax reduction but a full import duty exemption for investment in M&E, the METR for foreign investors in Jordan is 12 percent for manufacturing industry and 18 percent for the service sector. (See the correspondence between Table 4.2, Case 1 and Table 3.3, Case 1.)

[32] This is according to our reading of the tax law as interpreted in the publication of IBFD.

This result does not change Jordan's tax competitiveness for manufacturing, but will make Jordan the most attractive location in the region for foreign investment in the services sector, should tax cost be the only factor in the investment decision.

The tax costs for foreign investors in Jordan's services sector could be further reduced to 17 percent, should government decide to tax all business sectors at a flat rate of 15 percent. (See Table 4.3, Case 1A.[33]) Alternatively, if a 20-percent investment allowance were provided for investment in M&E by all sectors without changing the current income tax rates, METR for foreign investors in both manufacturing and services could be reduced by 1 percentage point to 11 percent and 17 percent, respectively. (See Table 4.2, Case 2.) In either of the above simulations, the gap in METR for foreign investors in Jordan between the manufacturing and service sectors would narrow from 17 percentage points to below 7 percentage points.

4.3: The Case of Ireland

Ireland's "economic miracle" has long been admired by many developing countries. To be sure, this miracle is attributable to a combination of factors in addition to the country's efficient tax system, such as its access to the European market, investments in education, and robust national effort to attract investment. However, its advanced tax system has been shown to be a major component of the Irish success story, as it has encouraged businesses to relocate and hire the country's newly trained skilled workers.

Indeed, tax incentives have been a key element to Ireland's successful efforts over the past two decades to encourage capital investment. However, the fundamental difference between Ireland's incentive program and those of most other developing countries in that Ireland does not apply the incentives on highly selective basis. For example, when the country's low income tax rate of 10 percent was first introduced in 1981, it was applicable to a wide range of manufacturing industries, with no time limit or pre-approval required.[34] Later, the 10-percent category was broadened to include banking and financial services, and this extension apparently attracted financial services companies to relocate their headquarters in the country. By 2004, the distinction among different sources of income has been eliminated, and all corporate income will henceforth be taxed at a 12.5 percent rate.

Ireland has also actively used an accelerated depreciation allowance to attract long-term capital investment. This accelerated depreciation allowance may take the form of an initial allowance or "free" depreciation at any time for any firm entitled to the aforementioned low income tax rate of 10 percent, again with no pre-approval required. The initial allowance must be claimed up to the full amount available or not at all, which may be most suitable for profitable companies that use the proceeds to upgrade or increase their capital capacity. The "free" depreciation may be claimed as any amount between zero and the maximum amount available up to unclaimed capital cost. This provision is particularly suited to startup companies, which can use up all the tax depreciation allowance before paying any income taxes once they become profitable. This type of incentive has the effect of a "tax holiday" for startup firms and encourages long-term capital expansion, but prevents conventional tax holiday "owners" from escaping tax liability after they become profitable. More importantly, the automatic implementation of a transparent law and regulation is in harmony with market efficiency.

Other features of Ireland's tax structure shown in Table 4.1 are in striking contrast to those in Jordan and its competitor countries. Ireland has a flat and much lower income tax rate applicable to all trading income, and has no other revenue-based levies like Jordan and Tunisia. Furthermore, Ireland taxes all financial investment income, such as interest, dividends and capital gains at a single rate of 20 percent. While this is not necessarily the fairest practice, it is certainly the most efficient and

[33] This simulation is for illustrative purposes only with no policy implications.
[34] See IBFD, Ireland (pp.98-102) for further information.

simplest, since all forms of investment income are treated on the same basis, making it easier for the tax authorities to handle difficult problems related to the treatment of financial income. Perhaps the most important feature of Ireland's incentive program is that it does not provide any tax holidays. Having no erosion of its tax base related to tax holidays or other forms of discretionary tax concessions is perhaps the principal reason that Ireland can afford to give all business taxpayers a unified low income tax rate of 12.5 percent.

For analytical purposes, Table 4.4 presents a comparison between Jordan and Ireland's tax cost to foreign investors. While Ireland is obviously not a competitor to Jordan, its tax regime is a possible role model.

Table 4.4: Comparison of METR on FDI Between Jordan and Ireland (%)

	Ireland	Jordan			
		Current Case	Case 1	Case 1A	Case 2
Manufacturing	12.4	7.7	11.6	11.6	10.6
Services	16.6	24.3	17.9	16.7	17.3
Sectoral Gap in METR (% points)	4.2	16.7	6.3	5.2	6.7

Key

Current case	Zone A incentive for manufacturing. No incentive for services.
Case 1	Exempt import duty on M&E for all sectors and eliminate income tax reduction by incentive zone
Case 1A	Apply 15% income tax to all sectors and exempt import duty on M&E for all sectors
Case 2	Case 1, plus 20% investment allowance

Current Case

This is the case with the Zone A incentive for manufacturing and no incentive for a broad range of services. This is to say, manufacturing industry is subject to the 11.25 percent income tax rate for 10 years before paying the regular 15 percent income tax and enjoys an import duty exemption for M&E. The service sector is subject to the 25 percent income tax rate with no import duty exemption for M&E but can double up the annual depreciation allowance for tax purposes.

Case 1

No income tax reduction is allowed, but the import duty exemption for M&E is available to all sectors. This is to say, with the same incentive for investment in M&E, manufacturing industry is subject to the current 15 percent income tax rate and services to the current 25 percent rate, but both manufacturing and service firms may double up the annual depreciation allowance for tax purposes.

Case 1A

In addition to Case 1, the current 25 percent income tax rate is reduced to 15 percent so that the entire services sector would be subject to a 15 percent income tax rate, which is the same as that currently for manufacturing industry. Note that this simulation is not intended to recommend any specific tax rate, but rather to illustrate the effectiveness of a flat income tax rate in alleviating the present inter-sectoral tax distortion.

Case 2

As an alternative to Case 1A, a 20 percent investment allowance is provided to investment in M&E in all sectors.

As shown in Table 4.4, Current Case, the METR in Jordan is about 5 percentage points lower for manufacturing and 8 percentage points higher for services than that in Ireland. However, the gap in METR for foreign investors between the manufacturing and service sectors is 17 percentage points in Jordan, compared with 4 percentage points in Ireland.

By eliminating the income tax reduction for manufacturing and expanding the import duty exemption for M&E to cover all business sectors, the METR in Jordan's manufacturing and service sectors will be both closer to Ireland's level, with 12 percent for manufacturing and 18 percent for the service sector (See Table 4.4, Case 1.) The most striking result from this action would be that the gap in tax

cost for foreign investors in Jordan's manufacturing and service sectors will be narrowed from 17 to 6 percentage points, which is a significant reduction in the current sectoral tax distortion.

This improvement in tax distortion may be enhanced by taxing all the sectors at a single rate of 15 percent. (See Table 4.4, Case 1A.) An alternative move of providing an investment allowance at 20 percent may further reduce the METR for foreign investors in both the manufacturing and service sectors. (See Table 4.4, Case 2.)

As a comparison between all the simulations for Jordan shows, however, taxing all the sectors at a flat income tax rate (Case 1A) will minimize the tax distortion between the manufacturing and service sectors.

It should be kept in mind that the comparison of METR for foreign investors in Ireland and Jordan is not the most relevant factor in actual competition between the two countries for FDI since their fundamental, non-tax conditions (e.g., geographic location) for capital investment are very different. Instead, this comparison reveals the major inefficiencies of Jordan's tax and incentive structure when compared with those of a model tax structure such as that of Ireland. For example, Ireland's single income tax rate on trading income of 12.5 percent, in the absence of other revenue-based taxes and income tax holidays or reductions, all contribute to the simplicity, efficiency, and fairness of its income tax system.

CHAPTER 5: ALTERNATIVE TAX INCENTIVES FOR JORDAN

The principal objective of this study is to design a program of investment incentives that provides import duty exemption for fixed assets and income tax exemption for selected sectors, of a certain magnitude, for a limited period, and by investment location in line with government specification of development zones. A related task is to identify the conditions for granting or extending these incentives in terms of requirements for firm reorganization and capacity expansion. These tasks are intended to accommodate the philosophy and framework of IPL 1995 in The Investment Law. (See Annex 2 for the Scope of Work for this consultancy.)

Instead of continuing the complexity of the existing investment incentive program, which has been formulated on a highly-selective basis in terms of sectors, regions, conditional exemptions, and length of period for qualifying for tax incentives, we propose a universally-available tax incentive program that will improve both efficiency and fairness, while fitting into the overall tax structure, thereby avoiding unnecessary, additional administrative and compliance costs.

We have performed a revenue simulation to assess the benefits of these proposed changes, based on the best data available. (See Annex 9 for the procedures used for this simulation.) Because of limitations on data availability, all the estimates of immediate revenue impact are based on data for 2001, which is used as the "base year" for our simulation.[35] An annual growth rate of 4.5 percent, based on GDP at current prices during the period from 1998 to 2003[36] is applied to every aspect of our revenue estimate for future years.[37]

5.1: Proposed Changes and Immediate Revenue Impacts

Change One

Eliminate all the selective income tax reductions or exemptions for any new investment projects in Jordan.

This change is aimed at restoring the tax base and alleviating existing tax distortions. This change would also help pave the road for a comprehensive tax reform.

Revenue impact

Assuming that all the incentives provided under the current investment incentive program for existing projects will be grandfathered and no firm that is entitled to the current incentives chooses to adopt the new investment incentives recommended below, this option will not affect tax revenue by changing the existing tax base.[38] Since no more income tax exemptions or reductions will be granted to any new investment projects, however, revenue arising from these new investment projects will be taxable. If adopted, therefore, this option will increase the tax revenue collected from new investment projects. Our estimate of the annual revenue gain from this change ranges from JD5 million in the base year to JD42 million in Year 4 after the base year.

[35] As our estimates are based on 2001 data, they should be used mainly for illustrative purposes. When more recent data of better quality becomes available, the estimates presented here can be improved accordingly.
[36] Ministry of Finance, "Government Finance Bulletin," Vol. 6, No.2, March 2004.
[37] According to *The Jordan Times*, 17 May 2004, p.8, "Jordan's Minister of Finance expects the growth rate of gross domestic product (GDP) during the current year to reach 5 percent. Some observers will think this is on the high side, but the International Monetary Fund (IMF) accepted this optimistic prediction on the understanding that the full potential of Jordan's economic growth could be 6 per cent, a rate that official economists think can be reached in the medium term, if the dust settles in the Middle East." Also, the average annual growth rate in tax revenue from "corporations" was 4.9% during the period 1997–2003.
[38] See Section 5.2 for the revenue impact where firms may opt for the new investment incentives by foregoing the current ones.

Change Two

Exempt import duty for all M&E, including spare parts imported by all investors for business purposes.

This change is aimed at directly reducing the cost of capital in M&E so as to promote investment in advanced technology and upgrade M&E, both of which are certain to improve productivity in Jordan.

Revenue impact

The direct impact of this change is an up-front loss from exempting import duty for M&E imported by those firms that are not entitled to the import duty exemption under the current investment incentives. Taking into account the fact that the import duty exemption will reduce the cost of capital that can be written off for income tax purposes, the net revenue loss is JD8.5 million.

This revenue loss, however, should be seen as a one-time loss, which has been planned and factored into the government revenue budget in the long term. Our proposed change only speeds up the government plan for a fraction of the proposed reduction in import duties. The reasoning is as follows.

There has been a trend for most developing countries to replace the traditional assortment of taxes on imports and domestic goods by a destination-based value-added tax. Jordan has been moving in this direction since 1994, by replacing The Consumption Tax Law with The General Sales Tax Law. The implementation of the Law on Unification of Fees and Taxes Levied on Imported Goods and Re-exported Goods in March 1997 has since steadily reduced the overall import duty revenue at an average annual rate above 7 percent.

Furthermore, according to the free trade agreements Jordan signed with the United States and the European Union, the import duty in Jordan on M&E imported from those countries will be reduced to zero by the end of 2011 and May 2014, respectively. In fact, 60 percent of all the M&E items imported from the United States will be duty free by January 2005, and 60 percent of M&E items imported from the European Union will be duty-free by May 2006. Also, in April 2004, the GST rate was further increased by 3 percentage points.

As a result of these events, revenue from import duty has steadily dropped, while GST revenue on imported goods has steadily grown. In its 2004 budget, the Ministry of Finance predicts the revenue from import duties will be reduced by JD18 million from JD202 million in 2003 to JD184 million in 2004, and revenue from GST on imported goods will be increased by JD46 million to JD280 million from JD234 million, which is a net increment of JD28 million.[39].

By incorporating all these factors, the revenue loss of JD 8.5 million from an immediate total import duty exemption for all M&E will be more than offset. Therefore, this loss will be included in our estimate of overall revenue impact as a memorandum item, rather than an on-going factor.

Change Three

Provide a 20-percent initial allowance for investment in M&E in all business sectors.

This change is aimed at encouraging overall capital investment while avoiding the potential abuse related to limited periods of tax exemptions or tax reductions. With the new incentive, firms are provided with faster or more generous write-offs for M&E and hence encouraged to adopt new technology and expand production capacity at a faster pace.[40]

[39] Refer to Ministry of Finance, "Government Finance Bulletin," Table 9, Vol. 6, No.2, March 2004.

[40] Theoretically, the initial allowance should be also provided for investment in buildings which are complementary to investment in machinery and equipment. Such an initial allowance may be provided for buildings in Jordan when the owner-used buildings are properly taxed under the property tax.

Revenue impact

Providing a 20-percent initial allowance for all M&E investment made by firms that are not entitled to the current investment incentive program will lead to a revenue loss in the base year of JD6 million.

However, as a form of accelerated depreciation allowance, an investment allowance does not alter the total amount of capital cost to be depreciated. Rather, it increases the present value of the claims by shifting them closer to the time of the investment.[41] Accordingly, the true revenue loss, which is equivalent to the tax benefit to taxpayers in financial terms, is the difference in the present value of accumulated capital allowances between the case with an initial allowance and that without the initial allowance.

Change Four

Provide an expense election for a maximum amount of capital investment to support the growth of SMEs.

Under this provision, SMEs may elect to expense their capital investment up to a limit during the year the investment is made and may carry forward the balance above that limit for future depreciation allowances.

The current incentive program appears to ignore SMEs, most of which are carrying on business in service sectors that range from small vegetable stands to professional consulting and training.

Special incentives for small businesses are potentially inefficient since they may encourage the breakup of companies, as well as penalize those that do grow and hence risk losing the small business incentive. However, properly designed incentives such as an election for expensing capital investment may help simplify tax calculations for SMEs.

More importantly, by allowing SMEs to write off capital expenditure up front, this incentive can help relieve them from the usual cash flow concerns during their startup years and period of capital expansion. Such a tax incentive has long been provided in the United States, which may provide legal reference and regulatory experience for Jordan in terms of how to identify an SME and how to prevent potential tax abuse after allowing SMEs to elect expensing their capital investment.[42]

Along with its positive impact on the growth of SMEs, the revenue impact of this change is not large, depending on how small businesses are defined, presumably using turnover. However, owing to the lack of data and pending the development of specific regulations to support the proposed change, no estimate of the revenue impact of the proposed change is developed at this time.

5.2: Overall Revenue Impact

By implementing the first three options outlined above, the proposed new investment incentive program incorporates an import duty exemption and an initial allowance for investment in M&E in all sectors, excluding those which can and will keep enjoying the incentives provided under the current investment incentive program.

[41] For example, under Jordan's income tax law, the annual depreciation allowance for furniture used by hotels and hospitals is 15 percent using the straight-line method of depreciation. Without an initial investment allowance, this type of furniture can be written off over six and two-thirds years. With a 20 percent initial investment allowance, firms can write off 35 percent of the capital cost of this type of furniture (i.e., the 20 percent investment allowance, plus the 15 percent annual allowance) during the year of the investment and write the 65 percent balance off over the next four and one-third years. As a result the total number of years required to write off this investment will be reduced by one and one-third years, and, using a 10 percent nominal discounting rate, the present value of the total tax allowance for this asset will be increased by eight percent for taxpayers.

[42] See the U.S. Internal Revenue Service publication on "Expense Election," Section 179 property for further information. (http://www.irs.gov/publications/p946/ch02.html)

Several questions arise on the overall, long-term revenue impact of these measures. First, what is the revenue impact from the actions of those firms that are entitled to continue under the current investment incentive program, but opt instead to participate in the new incentive program? Second, what is the ongoing revenue impact of providing import duty exemptions and initial depreciation allowances?

Firms Switching from Current to new Incentive Program

We need first to identify which firms that are entitled to the current investment incentives will opt to switch to the new program. It is reasonable to assume that only those firms that will gain more tax benefits under the new incentive program will opt out. Measured by METR, a greater tax benefit is associated with a lower METR.

Our estimate, based on data provided by JIB and the Income Tax Department, shows that 60 percent of manufacturing firms are currently located in Zone A, and half of these firms enjoy a lower income tax rate of 11.25 percent under the current investment incentive program. By paying less income tax, however, these firms are denied the benefit that is available to regular taxpaying firms of accelerating annual depreciation at up to 200 percent of the regular rate. Therefore, these firms will be better off paying the regular 15 percent rate, instead of the reduced 11.25 percent rate, while enjoying the import duty exemption for M&E investment under the new incentive program. The additional 20 percent initial investment allowance will give these firms a greater tax advantage than they would have if they choose to remain in the current investment incentive program.

These arguments are supported by the lower METR of 10.5 percent for these manufacturing firms in Table 3.3, Case 1 and 9.4 percent in Table 3.3, Case 2, in comparison with 10.7 percent for Zone A in Table 3.3. Similar comparisons can be made for mining firms located in Zone A, but the share of mining sector in Zone A activity is very small and hence negligible. By assuming that all these firms will opt for the new incentive program to gain greater tax benefits, the immediate revenue loss will be below JD100,000.

Supply-side Revenue Impact

With full implementation of the new investment incentive program including the universal import duty exemption and initial allowance for investment in M&E, the overall METR will be reduced from 14.2 percent to 13.5 percent. This indicates a 6 percent reduction in the overall cost of capital. Other things being equal, a lower cost of capital should be a stimulating factor for capital investment and economic growth. But the magnitude of this stimulating effect depends on the elasticity of capital stock with respect to the cost of capital.

By applying a unit elasticity of capital stock to the cost of capital, which is the mid-point found in various studies, this reduction in the overall cost of capital can be translated into an increment in company income tax revenue of more than JD10 million within a period of five years.[43] In other words, we take a rather conservative stance and assume the response of capital investment to the reduction in overall cost of capital will take five years to fully materialize, which is a relatively long period.

Table 5.1 presents our estimate of the total revenue impact from these measures over a period of five years, including the base year when the changes in the investment incentive program proposed are adopted.

[43] See Mintz (1995).

Table 5.1: Revenue Impact Simulation of Recommended Tax Changes (JD million)

	Base year	Year 1	Year 2	Year 3	Year 4
Recommendation 1	4.6	11.8	21.6	31.8	42.5
Recommendation 2	(8.5)	*This is a one-time loss, to be spread over a longer term.*			
Recommendation 3	(6.6)	(8.0)	(9.7)	(11.8)	(14.3)
Recommendation 4	*The impact is insignificant, as explained in the text.*				
Switching impact	(0.1)	(0.2)	(0.4)	(0.6)	(0.8)
Supply-side impact	2.2	4.6	6.9	9.2	11.5
Overall impact (1)	(8.4)				
Overall impact (2)	0.1	8.1	18.4	28.6	38.9

Key

Recommendation 1	Eliminate the current income tax exemption or reduction for new capital investment projects
Recommendation 2	Exempt import duty on M&E imported by all sectors for business use
Recommendation 3	Provide a 20 percent initial allowance for investment in M&E
Recommendation 4	Provide an election for small and medium enterprises to expend their capital investment up to a limit
Switching impact	Potential revenue impact arising from firms opting for the new incentives and foregoing the current ones
Supply-side impact	Revenue impact arising from the reduction of overall cost of capital resulted from all the recommended changes
Overall impact (1)	Sum of the above changes, including the one-time revenue loss from proposed import duty exemption for M&E
Overall impact (2)	Sum of the above changes, excluding the one-time revenue loss from proposed import duty exemption for M&E

Notes

Simulations use 2001 statistics for the base year, and assume an annual growth rate of 4.5 percent.

Table 5.1 shows that if we ignore the one-time revenue loss from the unconditional import duty exemption for M&E, the net revenue impact during the base year when all the proposed changes are adopted will be positive, although relatively insignificant: an increase of about JD 100,000. As capital investment grows in response to the new incentives that are now available in all sectors of the economy, however, we expect the collection of company income tax to grow steadily in the longer term.

5.3: Discussion of Other Suggested Changes

Several issues that emerged during our survey of firms as possible areas of confusion are clarified in the following discussion.

Incentives for Labor Training

The firm survey produced several suggestions on providing tax incentives for training. Some firms asked for exemption of all training expenses from income tax. This suggestion may reflect confusion on how the current income tax law treats the cost of training.

In fact, the current income tax structure in Jordan, consistent with the international norm, provides a full tax allowance for training costs.[44] The conditions for training costs in Jordan to be tax-deductible include the following.

- A training course for employees should not exceed six months
- The training course does not result in an academic degree
- The training cost is paid by the employer and hence a true cost of business

These conditions are fair and feasible from both administration and compliance perspectives. Accordingly, we do not consider it to be necessary to provide further incentives related to training costs under the tax system.

Confusion on this issue may arise due to unawareness of the availability of a full allowance in Jordan for training costs, which was introduced in 1996. The original regulation issued in 1985 allowed for writing off training costs up to only one percent of profit. This procedure may have been followed by some taxpayers even after the implementation of the 1996 regulation. If this is the case, the tax

[44] Refer to "Regulation No. 4 of 1996," pursuant to "The Income Tax Law of 1985" and its amendments.

authority may need to make greater efforts to bring taxpayers' understanding of the tax law and related regulations up to date.

Meanwhile, no change should be made to the tax law in relation to training costs without further investigation. For example, a one-percent withholding tax on company income is currently provided for vocational training purposes. This withholding tax need not be remitted if it is indeed used for training purposes. This type of levy complicates the tax structure and provides room for tax abuse, without any revenue benefit to government.

For example, when there is no real need for training, taxable income would be increased if there were no withholding tax for training purposes. Since no one wants to remit this tax to the government, however, the money withheld for this purpose is likely to be spent on "training," even if there is no real need for training. This withholding tax is at least redundant to the full allowance for training cost and should be eliminated.

Issues Related to Jordan's GST

Large hotels have lobbied intensively for a lower sales tax on hotel bills with the stated objective of promoting the tourist industry. They were recently successful in their advocacy. As of 1 June 2004, a sales tax of 7 percent (versus the GST rate of 16 percent) shall be applied to the hotel room rate (excluding any other hotel outlets such as restaurants).[45] This latest special rate of sales tax for hotels was introduced on the basis that it can be renewed annually.

The original argument for this special hotel sales tax was that hotel services rendered to foreign guests are like exporting goods and hence should be exempted from the value-added tax. But foreign tourists staying in Jordan's hotels are enjoying services provided in Jordan, which is different from their enjoying at home goods bought from Jordan.

The destination principle, which is the principle underlying levy of a value-added tax or any other sales tax, requires that a sales tax be levied in the place where the goods or services are consumed, regardless of the nationality of consumers.[46]

Furthermore, the argument for this tax reduction was couched in terms of attracting foreign tourists. However, Jordanian tourists will also benefit from this lower tax rate, while all Jordanians will pay the general higher value-added tax rate on other goods and services to compensate. Since higher-income Jordanians make much greater use of hotel services than the rest of Jordan's population, the equity implications of this tax break for the rich are distinctly unappealing. This aspect of the tax break will be difficult to defend when it becomes known to the public.

In addition, hotels are only a part of the tourist industry. Capital investment needs to be encouraged in a broad range of tourism facilities besides hotels in Jordan by the provision of even-handed incentives. To this end, incentives such as an import duty exemption and initial investment allowances for M&E would be preferable to a selective sales tax reduction.

Finally, the proposed reduction in the value-added tax rate for hotels would undoubtedly encourage other groups that think their interests are equally worthy of comparable tax reductions, with further erosion likely to result in the value-added tax base.[47]

[45] See official memo No. 51/1/4829 by the Ministry of Tourism and Antiquities.

[46] We observe that, with a general value-added tax rate of 21%, Ireland applies a lower value-added tax rate of 13.5% on a broad range of services, including certain public utility services, newspapers, certain tourist-related services including hotel accommodation, admission to cinemas and certain performances of the arts, services of veterinary surgeons, repair and maintenance of movable goods, photographic and similar services, and driving instruction. (See Price Waterhouse Coopers (2003) for more information.) While undesirable, this practice differs from that of reducing the general value-added tax rate to favor only a highly-selective interest groups.

[47] The consensus among tax experts is that "once any preference is allowed, we may begin to slide down the slippery slope to more preferences." The problem is that "every preference is a penalty for someone else, because it requires tax rates to be higher than otherwise." Slemrod and Bakija (1996)

Border Exemptions for Sales Tax

The desire to have a sales tax exemption at the border is also popular. This is mainly a result of the excessive length of the period required to obtain a refund for the sales tax paid on imported business inputs.

The practice in Jordan is as follows. Firms may credit their sales tax paid on business inputs against the sales tax collected on the goods and services they sell. When there is no sales tax collection that can be used to offset the sales tax paid on business input for a period of "at least six months," however, firms may claim the refund for the sales tax paid on inputs and their claim shall be repaid "within a period not exceeding 3 months."[48]

This possible nine-month period for refunding the sales tax paid on business inputs can obviously cause significant cash flow problems to business taxpayers and to start-up firms in particular. Furthermore, the real value of the refunds is eroded with inflation over time, imposing an effective import duty on goods. This problem should be dealt with, however, by speeding up the refund process rather than by providing exemptions at the border for some firms.

[48] See "The General Sales Tax Law of 1994," Chapter 6 for further information.

CHAPTER 6: RECOMMENDATIONS

We are of the opinion that any fiscal incentive program should be formulated as an integral part of the overall tax system. *Ad hoc* advocacy of tax incentives, whether by government officials or interest groups, can lead to erosion of the overall tax base and hence a need to increase taxes on other taxpayers to compensate for the resulting shortfall in government revenue.

Based on the principles of efficiency, simplicity, and fairness and following international best practice, the currently cumbersome and inefficient investment incentive program in Jordan should accordingly be replaced by a simpler and more efficient program that is directly linked to capital investment. Accordingly, instead of following past practice and recommending new discretionary incentives, we have chosen to design an investment incentive program that would be available to all business sectors, in all geographic locations, and at any stage of the business life of firms. The only condition for qualifying for this new investment incentive program is to invest in Jordan's economy with no pre-approval whatsoever.

Anticipating comprehensive tax reform in the future that will lead to a modern tax system in Jordan, our recommendations for reformulating the current incentive program are aimed at improving Jordan's tax competitiveness in the region, alleviating current tax distortions that negatively impact the efficiency of capital allocation, improving government's capacity to generate tax revenue in the long run, and improving tax and incentive administration by eliminating undesirable administrative layers, all while operating within the current tax system.

Recommendation One

No longer grant the income tax exemptions and reductions specified for new investment projects under the current investment incentive program.

While this resolution applies to all new investments, two options should be made available to those firms that have been granted incentives under the current incentive program. First, they may continue receiving their current incentives until their expiry date. In this way, incentives granted before the implementation of the new program are honored or "grandfathered," in order to fulfill legal commitments made in the past by government. Second, they may opt to receive the new incentives, which are outlined in Recommendations 2-4.

Recommendation Two

Expand the import duty exemption for fixed capital assets from the selected sectors that are favored by the current program to all business sectors.

This recommendation applies to all capital inputs, mainly M&E including spare parts and furniture, imported by investors for business use.

This exemption should be implemented alongside the general reduction in import duty that was initiated in 1997 as part of the "Law for Unifying Fees and Taxes Levied upon Imported Goods and Re-exported Goods."

Furthermore, this recommendation is in line with the *Jordan Vision 2020* recommendation that the "responsibility for qualifying and monitoring the customs and tariff waivers granted to investors" be transferred "from the Investment Promotion Corporation (Jordan Investment Board) to the Customs Department, where it more properly belongs."

This recommendation will not only reduce and ultimately eliminate import duties on capital goods, but will also help to modernize administrative procedures at the Customs Department. A guideline on how to identify capital goods imported for business use should be provided by the Ministry of Industry & Trade. We assume such a guideline is available and used by JIB for granting import duty exemption under the current investment incentive program. If this assumption is valid, then the

existing guideline can be adopted by the Customs Department for implementing the unconditional import duty exemption for M&E recommended here.

Recommendation Three

Provide a 20-percent investment allowance for capital invested in M&E (including furniture) used for any business purpose.

This proposed initial investment allowance would be offered during the year when capital is invested. Such an investment allowance would be provided in addition to the annual depreciation allowance, although the cost of capital for annual depreciation would also be reduced by the investment allowance. It should also be made possible for any unclaimed investment allowance during the investment year to be carried forward for ten years, which is chosen to be equivalent to the number of years for which the tax reduction is granted under the current investment incentive program.

This investment allowance for M&E, if adopted, should be provided to all investors in all economic sectors with no conditions whatsoever. Administration of this provision should be the responsibility of the Income Tax Department as a part of processing annual tax returns, without any pre-approval. Therefore, tax assessors at the Income Tax Department need to be informed and trained to bring this change into their auditing process.

Furthermore, if the Income Tax Department is designing a standardized tax return form that includes procedures for reconciling accounting profit and taxable income, then procedures for calculating the initial allowance should be included in this tax return form. Otherwise, no additional layer of administration will be imposed as a result of this change.

Recommendation Four

Provide an expense election for a limited amount of capital investment on an annual basis to support the growth of SMEs.

SMEs usually have very limited access to funding for capital investment, and the size of their annual capital investment tends to be small. The growth of SMEs, however, is considered critical to more rapid economic growth in the economy as a whole.

Under this proposed expense election for capital investment, SMEs could choose to write off their annual capital investment immediately, up to the maximum amount (e.g., JD10,000), rather than relying on the conventional depreciation allowance. Any unclaimed balance of this maximum amount arising from inadequate operating profits should also be included in the base against which annual depreciation allowance can be claimed in the future. This incentive will provide SMEs with a cushion of cash flow during their startup years, which may be vital to their survival.

If adopted, this measure should be administered by the Income Tax Department as a part of processing annual tax returns, without any pre-approval. The Ministry of Industry & Trade and the Ministry of Finance should jointly create guidelines on the definition of an SME, as well as the maximum amount of capital investment allowed to be expensed under this provision.[49]

To err on the side of caution, the maximum amount allowed for this expense election initially should be no more than JD10,000.

The size of the expense election can be adjusted subsequently to take into account its economic impact and administrative cost. It is understood that this recommendation may not be implementable until the aforementioned guideline becomes available and familiar to tax assessors at the Income Tax Department.

[49] The USAID-funded AMIR Program is currently undertaking a short-term consultancy to develop a definition of SMEs appropriate to Jordanian government procurement practices as part of its support to government in acceding to the Government Procurement Agreement, a multilateral agreement of the World Trade Organization.

In summary, restructuring Jordan's currently cumbersome investment incentive scheme should be seen as the very first step towards creating a more desirable tax environment for capital investment in Jordan. While the complexity and inefficiency of the current tax system is not unusual in the region, Jordan can take the lead in reforming its tax system and will reap significant benefits accordingly.

It should be noted, however, that tax reform is an ambitious undertaking, which encompasses far more than this report can suggest. In particular, it requires a comprehensive review of both tax structure and tax administration. See Annex 12 for a list of areas that we suggest be given priority in such a review.

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ANNEX 2: SCOPE OF WORK

This program must address the following issues, which must in turn be addressed by the regulations supporting The Investment Law of 2003.

- The bases, provisions, procedures, percentages, periods and conditions relating to exemptions from fees and taxes
- The development areas in the Kingdom which confer exemptions from fees and taxes, and the conditions and provisions relating to granting such exemptions
- The exempted sectors and their branches
- The bases for exemption of a project operating within the sectors exempted from income and social development taxes, the percentage of such exemption, and its period according to the development area in which it is located
- The provisions and periods related to the exemption of fixed assets and spare parts
- The provisions related to additional exemptions which may be granted when expanding a project
- The bases and conditions required to grant exemptions for a new project resulting from merging two projects or more

This program must also address any additional incentives that may be granted through JIEC.

ANNEX 3: OVERVIEW OF BUSINESS TAXATION IN JORDAN[50]

This annex provides an overview of the three major business taxes in Jordan: capital taxes, transaction taxes on business inputs, and payroll taxes. Against this background, three major investment incentive regimes are also reviewed.

3.1 Taxes on Capital Investments

As Table 1 showed earlier, capital taxes in Jordan include the direct tax on business income, personal income taxes on investment income [51,] and the tax on land and property.

Business Income Taxes

The business income tax is imposed on net profit with certain expenses being deductible. A three-tier tax scheme is applied according to the nature of business. The lowest rate of 15 percent is applicable to income generated from industry, including mining and manufacturing[52], hotels, hospitals, transportation, and construction. The highest rate of 35 percent applies on profits made in the financial sector by banks and financial companies. An intermediate rate of 25 percent is applicable to other sectors including insurance companies, exchange companies and intermediation companies, communications, services, commercial companies, and to any other company not included in the aforementioned first two categories of businesses.

There are two additional taxes payable based on business income but with somewhat different taxable bases. One is the university tax on net profit before tax, and the other is a tax for vocational training purposes levied on distributable profit[53]. The rate for both taxes is 1 percent, and both taxes are deductible for income tax purpose. Therefore, in the case that these taxes are truly payable, the effective income tax rate will be higher than the standard income tax rates listed above[54]. It is noteworthy, however, that the training tax does not need to be remitted if it is used for training employees by the firm.

Capital-related Tax Allowances

Depreciation allowance is calculated by the straight-line (SL) method. The annual allowance for buildings is 4 percent for those having operating M&E and 2 percent for regular buildings in non-manufacturing use. A 10 percent depreciation allowance is available for non-durable buildings or structures that can be disassembled, transported and reassembled. The annual allowance for the majority of furniture and fixtures is 10 percent in general and 15 percent if used by hospitality and recreational sectors including hotels and hospitals. For M&E, the annual allowance generally ranges from 10 percent for those operated with electric power to 15 percent for those using other forms of power or involving electronic systems. An exceptionally generous depreciation allowance of 25 percent is available for electronic machinery, such as computers and computerized devices or computer-controlled machines. Other equipment, such as wood and metal girders, and so on, may be depreciated at an annual allowance of 20 percent.

[50] This annex is based on the following documents. 1) Income Tax Law—Law No. 57 of 1985 as amended by: Law No. (4) of 1992, Law No. (14) of 1995, and Law No. (25) of 2001, and Law No. (39) of 2003 in its latest effective form. 2) Regulation No. (5) for 2002, Regulations of Depreciation. 3) Law No. (16) of 1995 and its amendments, The Investment Promotion Law. 4) Law No. (19) for the year 2001, The Social Security Law. 5) The Sales Tax Law, and 6) Ministry of Finance, Customs Department, "Jordanian customs tariff based on the Harmonized System."

[51] As illustrated by the effective tax rate analysis, taxes on any personal investment income could affect the cost of capital investment through the financing of capital.

[52] In the Income Tax Law, the sectors subject to this 15 percent income tax rate are: metallurgy, industry, hotels, hospitals, transportation, and constructional contracts.

[53] This tax is levied according to the Education and Technical, Vocational Training Council Law, No. (88) of 2001.

[54] The increment will be less than 2 percentage points as these taxes are deductible for the income tax purpose. For example, for sectors subject to the 15 percent income tax rate, the gross-up tax rate on income would be 16.7 percent (= 2 percent + 15 percent * (1 – 2 percent)).

There are three important points to be made about this system of depreciation allowances. First, taxpayers may increase the annual allowance for M&E up to the amount that doubles the regulated rates as mentioned above. Second, taxpayers may also reduce or completely postpone the available annual allowance to future years. However, this provision does not apply to any project that enjoys an income tax exemption or reduction. And finally, the first-year allowance is subject to the date when the assets are put in use. That is, assets that are put in use in the first half of the year are entitled to the full annual allowance while those put into use in the second half of the year only receive 50 percent of the annual allowance. However, after doubling the regulated rates, taxpayers may still claim 100 percent of the annual allowance even for that M&E that is put in use during the second half of year[55].

Inventory Accounting Method

For financial statements, year-end inventory has to be accounted at the lower of book value or market value. But, for tax purposes, as long as book keeping is based on historical cost, taxpayers may use any of the following three inventory depreciation provisions: first-in-first-out (FIFO), last-in-first-out (LIFO), or average cost. In practice, the majority of taxpayers adopt a weighted-average-cost method for tax purposes.

Loss Carry-Over

Business losses may be carried forward indefinitely. However, "a loss that if being a profit will not be taxable by provisions of this law shall not be allowed to be deducted."[56] That is, business losses incurred to a taxpayer who is enjoy income tax exemption or reduction will not be allowed to be carried forward.

Tax on Dividends, Interest, and Capital Gains

Except for banks and financial companies, investment incomes from these sources are taxed respectively in the following manner.

First, 75 percent of the dividends distributed by companies are exempt from tax with the remaining 25 percent being taxed as ordinary income in the hands of recipients—both individuals and companies. As such, the tax rate on the 25 percent of dividends varies among individual or company recipients depending on their overall taxable income and the related statutory income tax rate. It should be noticed that, if a company distributes dividends received from other companies to its shareholders, it will not be taxed on these distributed dividends.

Second, interest other than that received from banks is exempt from income tax. For interest received from banks including commissions and shareholding dividends received from Islamic Banks, the withholding tax is 5 percent. This tax is final for individuals and a down payment for companies.

Capital gains from all types of capital investment are exempted from income tax. It should be noted that this exemption does not apply to proceeds from disposal of depreciable assets that is governed by the regulation on depreciable assets.

For banks and financial companies, interest income is fully taxable. Capital gains are taxable as ordinary income with 25 percent of these incomes exempted as deemed expenses. Dividends received by banks and financial companies are taxed in the same manner as for other taxpayers. That is, only 25 percent of total dividends received are taxable as ordinary income.

Property Taxes

Property tax in Jordan is levied on buildings and underdeveloped land respectively. The tax base is the rental value of the property. For land, rental value is estimated as 2 percent of the market price of the land, and the tax rate is also 2 percent. For buildings, rental value is determined in two ways. For leased buildings, the rental value is the actual amount stated on the leasing contract.

[55] Refer to Regulation No. (5) of 2002 for details.
[56] Refer to Income Tax Law of 1985 and its amendments, Article (10) C.

For owner-occupied buildings, the rental value is estimated based on several criteria, including the geographic location, the quality of construction and materials, and the use of the building, such as residential, industrial or commercial[57]. The aggregate tax rate is 15 percent with 10 percent as direct property tax, 3 percent as a user fee payable to the Water Authority, and 2 percent as an education tax for the Ministry of Education, which is payable directly by the tenant.

These taxes are payable before the end of the current year, payment before June 30 being entitled to a discount of two percent for each two months from January to June. Late payment is subject to a fine amounting to ten percent of the tax owed for each year being delayed up to a maximum of 50 percent of tax owed.

Since this property tax is based on rental value and has a minor impact on owner-occupied buildings, whether residential or business, it is broadly perceived as being a component of income tax. In particular, net rental income[58] is also subject to the income tax. As such, the property tax is creditable against income tax payable with the latter acting as a ceiling for credit[59]. However, if the building is owned for business use, all the property taxes paid are deductible for income tax purposes.

Taxes and Fees on Property Transactions

These taxes are all based on the transaction price, and can be classified in the following way. The sales tax is 4 percent, the registration fee is 5 percent, the university fee is 0.5 percent, with an additional fee of 0.5 percent, or 10 percent of the registration fee. While the sales tax is payable by sellers, the other fees are payable by purchasers.

The sum of these taxes amounts to 10 percent of the total transaction price. There is also a 1 percent fee on the amount of mortgage obtained by purchasers, which raises the total transaction related levies above 10 percent. According to the Director General of Dept. of Lands and Survey, since these taxes encourage dishonesty by sellers and buyers in reporting the true transaction price, the tax base is often lower than the actual transaction price by 10 to 15 percent.

3.2 Transaction Taxes on Business Inputs

Besides the taxes and fees levied on property transactions, there are two main types of transaction taxes relevant to doing business in Jordan. The first is the import duty on production inputs including capital goods and material inputs. The import duty on the majority of capital goods is zero, except those that may be used for consumption, such as small power generators, electronic devices, furniture, and spare parts. In the latter case, the import duty ranges from 3 to 30 percent.

The second tax is the GST, and its tax rate is 16 percent. Since this tax is in principal a value-added-tax, it should not have any significant impact on capital investment. However, the current lengthy process for refunding the input tax credit may raise concerns about its costs in terms of cash flow. That is, firms investing heavily in capital goods where sales turnover may be lengthy, may have a long wait for refunds on sales tax paid on their purchased capital goods, in turn raising their interest expenses. Therefore, an exemption from this refundable sales tax on capital goods is seen as a valuable incentive to large-scale capital investors.

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[57] The government published detailed guidelines for per square meter rental value of each category of buildings. See publication (?) for reference. However, the current guideline was introduced in 2001 and presents only a 12.5 increment in that used since 1984. There is also a rental-freeze that is scheduled to be lifted in 2010 when landlords will be allowed to raise rents by 250 percent. As a result, market will anticipate a property boom as tenants prone to purchasing their own properties. [Incomprehensible footnote]

[58] This "net" rental income is gross rental income first net of all expenses (such as depreciation and other non-direct-property taxes such as user fees paid to the Water Authority) and then net of a 15 percent exemption in the greater Amman municipality and 30 percent in the remaining areas of the country

[59] In Law No. (30) for 2003,it was proposed that property tax would be deductible from the income tax . This law took effect in May 1, 2003. However, it was subsequently rejected by Parliament and cancelled accordingly on March 18th of 2004.

3.3. Payroll Taxes

The only payroll-based levy is the social security contribution payable by employers. The employer's contribution is 11 percent of wages, and the employee's is 5.5 percent.

There is also a "social service tax" payable by all individuals who pay the income tax. This is not a payroll-based tax, however, but a surtax of 10 percent on the amount of personal income tax due.

3.4 Structure of Tax Incentives

There are two types of general business tax incentives considered by this study: those provided under IPL 1995 and those provided under JIECL 1985.[60]

Under the IPL 1995, Jordan is divided into three development zones. Investments in industrial production, including mining and manufacturing, agriculture, hotels, hospitals, leisure and recreational compounds, conventions and exhibitions centers, maritime transport and railways enjoy an income tax reduction of 25 percent in Zone A, 50 percent in Zone B and 75 percent in Zone C for a period of ten years.

In addition, these investment projects are entitled to a 100 percent exemption of customs duties on imported fixed assets for the first three years from the commencement of operation. Extension of these tax incentives is available based on certain conditions.

Within the JIEC industrial estates, industrial projects enjoy a two-year full exemption from income tax on both company and individual income taxes and social services tax, as well as a permanent exemption from property taxes. Moreover, after the two-year income tax holiday ends, a 10-year reduction in company income tax will follow, and the degree of such tax reduction will depend on the zone location of the project.

[60] See Chapter Three for more details of the current incentive program.

ANNEX 4: QUESTIONS FOR JORDANIAN FIRMS THAT CURRENTLY ENJOY INVESTMENT INCENTIVES

Company profiles

Large firms that are currently enjoying investment incentives based on IPL 1995, some of which are located within public and private industrial estates and QIZs

Participants

Corporate financial officers or their best representatives who are familiar with company's financial and tax issues

Survey questions

What was your firm's main motivation in the first place to apply for the investment incentives? Was it for income tax reduction, or for import duty exemption, or for other tax concessions (e.g. property exemptions in the industrial estates), or for non-tax purposes (e.g. free access to the U.S market, or less red-tap in dealing with bureaucrats, etc.)?

How many years has your firm been in business since it obtained the investment incentives, and when will your firm's incentive period expire?

How do you value your firm's financial benefit from the investment incentives? Please specify these benefits by linking them directly to each category of incentives (i.e. income tax reduction, import duty exemption, property tax exemption, and other incentives if there are any)?

Is your firm paying any additional taxes which do not fall under the exemptions, such as: property tax, university tax (1% of pre-tax profits), training tax (1% of net profit after all the provisions based on the company law), custom fees (0.2%), and others?

Did your firm expand its production capacity in the past or is it planning to expand in the future? If so, what was/is the main driving force for such expansion? Did/do the extendable tax incentives play a role in such an expansion? If so, do you see the restrictive condition (i.e. that the expansion should be no less than 25% of the original capacity) as reasonable or not?

How would you like the government to change the current incentive program to make it more efficient and attractive to your firm's future investment decisions? More specifically:

Would you prefer that all sectors in Jordan (other than the banking sector) be taxed equally or differently? For either answer, please explain why? (e.g. prefer more transparency, better financial governance, more market efficiency, etc.)

If you were taxed equally like everyone else at the standard income tax rate, what kind of tax benefits you would like to have in order to offset the potential loss from eliminating the currently differentiated income tax regime (e.g. more generous depreciation allowance? Fewer non-income-tax charges, etc.)?

Any other comments?

ANNEX 5: METR METHODOLOGY FOR ESTIMATING INVESTMENT TAX

5.1 Concept

The marginal effective tax rate on capital investment calculated in our study is an effective tax rate on capital investment made by any legal entity that generates active income and is subject to the company income tax. It combines all the taxes that affect capital investment at the firm level instead of personal level. Personal income taxes, however, may be incorporated into our calculation when they affect the capital investment at the firm level. For example, the withholding taxes on dividends are common and certainly affect the cost of capital invested at the firm level through their impact on the rate of return to equity required by shareholders.

The marginal effective tax rate (METR) measures the impact of a tax system on an incremental unit of capital investment. It incorporates the effects of not only statutory tax rates, and other tax provisions, such as tax depreciation, tax credits, tax deductibility, and tax holidays, as well as various economic factors interacting with these tax provisions, such as financial costs, the inflation rate, and the structure of investment, In other words, METR is a summary indicator of the overall tax burden imposed by a tax system on a new investment within a given economic environment.

The primary assumption underlying the calculation for our estimate of METR is that of profit-maximization. Profit-maximizing firms base their investment decisions on the present value of foreseeable net revenues from investment. Taxes reduce the portion of the profits accruing to the investor, while tax allowances or credits mitigate such a reduction in accrued profits.

For profit-maximizing firms, the gross rate of return on capital, net of economic depreciation, must be equal to the financing cost of capital, adjusted for taxes. The size of this adjustment for taxes on a new investment is the marginal effective tax rate, or METR, on capital.

For example, if the gross-of-tax rate of return to capital is 20 per cent and the net-of-tax rate of return is 10 per cent, then the METR on capital is 50 per cent. Owing to the interaction between these statutory tax provisions and actual economic and industrial conditions, such as financing conditions and capital structure, METRs may vary by industry even under the same tax regime.

The second important assumption used in our METR analysis is the concept of a “small open economy.” In a small open economy, firms have the option of acquiring investment funds from both domestic and international markets; and the domestic market interest rate for a host country is determined by international trading of currencies.

Therefore, although international statistics may show variations in interest rates among countries under comparison, when foreign capital investment is involved, it is reasonable to assume that real interest is the same across all the home countries under comparison. Finally, to maximize profits, firms will always want to minimize the cost of financing by issuing debt until the tax-inclusive cost of debt financing equals the tax inclusive cost of equity financing.

Therefore, besides the interest deductibility for income purpose at the firm level, the gap between the personal income tax on interest and that on equity income, including capital gains and dividends, can also affect the financing structure as measured by the debt to equity ratio.

The METR analysis in this study deals with only “profitable” firms. By “profitable” we mean those firms that have taxable income and are not in a loss-carry-over position. This assumption is important, because a tax holiday is irrelevant to an unprofitable firm that does not have to pay income taxes. Furthermore, calculating METR for "tax-loss" firms would require data on the average number of years required for these firms to write off their losses and become taxable, which is beyond our policy concerns in the present report.

5.2 Methodology

The standard method used to estimate effective tax rates has been extensively documented[61]. The formula based on this method has been modified by incorporating some miscellaneous taxes[62] such as capital tax, property tax, and tax on transfer of property as in Jordan, and for foreign capital investment[63]. The following are the general formulas used in this study.

Effective Tax Rate (t)

The effective tax rate on a given type of capital is defined as the proportional difference between the gross-of-tax rate of return required by a firm (r^G) and the net-of-tax rate of return required by an investor (r^N). r^G is the marginal revenue product (or user cost of capital, in equilibrium) net of economic depreciation. The after-tax rate of return is the weighted average of the return to debt and equity securities held by the financial investor. Thus, the effective tax rate (t) is defined as

$$t = (r^G - r^N)/r^G \quad (1)$$

Real Cost of Financing (rf)

For domestic investors, the real cost of financing (r^f) is defined by

$$r^f = ßi(1 - U) + (1 - ß)\rho - \pi \quad (2)$$

with $ß$ = the ratio of debt to assets ratio, i = cost of debt, U = the statutory corporate income tax rate, ρ = cost of equity, and π = inflation rate. That is, the cost of financing for an investor is the weighted-average cost of financing net of the inflation rate.

For foreign investors, a realistic assumption is that the investors finance their capital in the host country using two sources of funds. The first is debt raised in the host country and the second is equity invested in the host country, the latter being comprised of both debt and equity raised at the home country. Therefore, there are three components in the real cost of financing (rf) for a foreign investor: debt and equity raised at home and debt raised in the host country. With different tax regimes at home countries, the cost of debt raised in the host country may be treated differently by the home tax regime. When the cost of debt raised in the host country can be fully deducted for the income tax purposes at home, the real cost of financing for a foreign investor is defined by the following equation:

$$r^f = [ß'i'(1 - U') + (1 - ß')\rho']*(1 -\gamma)/(1-x) + \gamma*[i(1-U) - \pi + \pi'] - \pi' \quad (2')$$

In this equation, all the home country variables are denoted by the symbol ‘, with $ß'$ = the ratio of debt to assets ratio in the home country, i' = cost of debt in the home country, U' = the statutory corporate income tax rate in the home country, ρ' = cost of equity in the home country, and π' = the inflation rate in the home country. In addition, γ = the ratio of debt raised in the host country to total investment funds, x = the weighted average withholding tax rate in the host country, i = cost of debt in the host country, U = the statutory corporate income tax rate in the host country, and π = the inflation rate in the host country.

As the equation (2’) states, the real cost of financing to a foreign investor is the weighted-average of the costs of its investment funds taken from the home country and the debt raised in the host country, net of the home country inflation rate. The former is the weighted average cost of financing at home net of withholding tax payable in the host country, and the latter is the cost of debt in the host country adjusted by income tax deductibility and any difference in the inflation rate between the home and host countries.

Equation (2’) is applicable to the French case in which all the taxes paid in a foreign country by the French multinationals are “spared.,” so a s the tax benefit available in the foreign country including the interest deductibility (e.g. expressed by term *i(1-U)* in the equation).

[61] Boadway, Bruce, and Mintz (1984) and King and Fullerton (1984).
[62] Chen and Mintz (1993).
[63] Mintz and Tsiopoulos (1992).

This equation may also be applicable to the U.S. case assuming that the U.S. investors in Jordan are in a "deficit credit" position regarding their income tax liability at home (see below for explanation).

The U.S. case is different from the French one in that taxes paid in foreign countries are not "spared" but creditable against the home tax liabilities. A further complication is that, since the implementation of the post 1986 interest allocation rule, the U.S. multinationals are disallowed to allocate their foreign interest cost across different foreign investment projects.

As a result, for each foreign country where a U.S. multinational is doing business and paying tax, its foreign tax creditability for that given country may be in either a "deficit credit" position or an "excess credit" position. In the "deficit credit" position, the foreign tax paid in a given country by a U.S. investor is below his tax liability at home corresponding to that given foreign income and hence can be fully credited against its home tax liability.

In contrast, in the "excess credit" position, the foreign tax paid in a given country by a U.S. investor surpasses his home tax liability corresponding to that given foreign income and hence cannot be fully credited against his home tax liability. Under this latter situation, all the formulas for foreign investors presented in this annex need to be modified by adding a "penalty" term to reflect the less-than-full credibility of foreign income tax paid[64].

In our study, we assume that the U.S. investors in Jordan are in a "deficit credit" position and hence do not incur any tax cost beyond their tax liability at home corresponding to their income generated in Jordan. This assumption is based on the fact that the overall Jordanian income tax rate (up to 35 percent) is lower than that in the U.S. (or at most equals that in the U.S. if there is no income tax levied at the state level).

Of course, when the tax allowances, such as the depreciation allowance in a host country is less generous than that at home, even a lower income tax rate in the host country compared to that at home may lead to an "excess credit" position for a multinational relating to its investment in that given host country.

We assume this situation is irrelevant to U.S. investment in Jordan. Also note that, for a given U.S. investor, assuming an "excess credit" position will generally result in a lower METR than assuming a "deficit credit" position. Therefore, the assumption in our METR comparison across different host countries that a representative U.S. investor is in a "deficit credit" position does not affect the METR ranking in our cross-country comparison in any material terms.

Net-Of-Tax Rate Of Return On Capital (rN)

For domestic investors, the net-of-tax rate of return on capital is defined by formula

$$r^N = ßi + (1 - ß)\rho - \pi \qquad (3)$$

This is the rate of return on capital required by financial investors, or suppliers of investment funds to firms. Note that financial investors often include firms themselves when there is equity generated internally.

For foreign investors, the formula is

$$r^{N'} = [ß'i'(1-U') + (1 - ß')\rho' - \pi'](1-\gamma) + \gamma(i-\pi) \qquad (3')$$

This is the net-of-tax rate of return on capital required by financial investors including foreign investors themselves and their creditors in both home and host countries.

Applying (3) and (3') to equation (1), respectively, results in the effective company tax rate on capital for domestic investors and that for foreign investors.

[64] Leechord and Mintz (1993)

Gross-of-Tax Rate of Return (rG) on Capital[65]

Depreciable Assets

For domestic investors:

$$r^G = (1+tm)(r^f + \delta)(1- k)[1 - A + \tau(1-U)/(\alpha + r^f + \pi)]/[(1-U)(1- tp - tg)] - \delta \quad (5)$$

Where tm = tax on transfer of property, or a transaction tax (e.g., import duty) on capital goods wherever this is applicable, δ = economic depreciation rate, k = investment tax credit rate, A = the present value of tax benefit from the investment allowance and depreciation allowance, τ = capital tax rate, α = tax depreciation rate, tp = property tax rate based on the rental value, and tg = gross receipts tax rate, or presumptive tax that is based on the gross revenue.

For foreign investors:

$$r^{G'} = (1+tm)(r^{f'} + \delta)(1- k)[1 - A + \tau(1-U)/(\alpha + r^{f'} + \pi)]/[(1-U)(1- tp - tg)] - \delta \quad (5')$$

Inventory

For domestic investors:

$$r^G = (1+tm)(r^f + U\pi\zeta)/[(1-U)(1-tg)] + \tau \quad (6)$$

Where tm = sales tax on raw materials where it is applicable, and ζ = 1 for the FIFO accounting method, 0 for LIFO, and 0.5 for the average cost method.

For foreign investors, the formula is the same except that the financing cost should be the one relevant to the foreign investors. That is, r^f should be replaced by $r^{f'}$.

Land

For domestic investors:

$$r^G = r^f (1+tm)\,[1 + \tau(1-U)/(r^f + \pi)]/[(1-U)(1- tp - tg)] \quad (7)$$

Where tm = property transfer tax.

For foreign investors, the formula is the same except that the financing cost should be the one relevant to the foreign investors, i.e., r^f should be replaced by $r^{f'}$.

Aggregation

The effective tax rate for a given industry is the proportional difference between the weighted average of the before-tax rate of return by asset type and the after-tax rate of return; the latter is the same across asset types within a given sector[66]. That is, the marginal effective tax rate for industry *i.* t_i, is calculated as following:

$$t_i = (\Sigma_j r^G{}_{ij} w_{ij} - r^N{}_i)/\Sigma_j r^G{}_{ij} w_{ij} \quad (8)$$

where j denotes asset type (i.e. investments in buildings, machinery, inventories, and land), and w_{ij} denotes the weight of asset type j in industry i.

Inter-sectoral METR Dispersion

The inter-sectoral METR dispersion coefficient is the weighted average of the standard deviations of METR by type of assets across industry. It is estimated as:

[65] Formulas provided here are only for the regular case where companies are profitable and pay taxes. For the tax-holiday case or the case of tax reduction for a limited period, the formulas for depreciable assets are more complicated in that the present value of tax allowances needs to be adjusted to reflect the true impact of the tax holiday or tax reduction on METR. For non-depreciable assets such as inventory and land, the formula for the tax-holiday case is the same as that for the taxpaying case except that the statutory tax rate(s) may differ due to the lower or zero rate arising from tax incentives.

[66] The net-of-tax rate of return can be the same across all the sectors when there is no sectoral differentiation in the statutory income tax rate.

$$\sigma = \Sigma_j w_j \{ \Sigma_i w_{ij} (t_{ij} - t_j)^2 \}^{1/2}$$

where t_{ij} is the effective tax rate on asset j for industry i, and t_j is the average effective tax rate for asset j across all industries.

ANNEX 6: IMPACT OF NON-TAX PARAMETERS ON METR ESTIMATES

Expected Inflation Rate

The expected inflation rate affects the effective tax rate on capital through its impact on the nominal interest rate. For a given real interest rate, the higher the inflation rate, the higher the nominal interest rate will be. *When there is no regulation for adjusting the inflation impact*, the nominal interest rate interacts with taxes mainly through the following three channels.

Firstly, interest cost is deductible for income tax purposes at the nominal rate. As a result, the higher the nominal interest rate in relation to a fixed real interest rate, the lower the real after-tax financing cost, and hence the lower the METR. This effect is particularly favourable for leveraged land financing.

Secondly, the accumulated present value of a given annual tax depreciation allowance decreases as the nominal interest rate rises. Since higher inflation lowers the present value of tax depreciation allowance, it increases METR on depreciable assets. And finally, if the first-in-first-out method is used for the inventory accounting, it may results in inflated taxable income and, hence, a higher METR on inventory when prices rise.

Since inflation thus affects METR on different assets in different directions, its net impact on capital will depend upon the capital structure related to a given industry. See the end section of this annex for further explanation of the capital structure by industry.

Expected Real Interest Rate

The impact of the real interest rate on the effective tax rate is in part similar to the impact of inflation. For example, as the real rate rises, so will the nominal rate, thus increasing the effective tax rate on depreciable assets. For a given debt-asset ratio, however, unless inflation is high, there is unlikely to be much of a distortion in effective tax rate arising from the deductibility of interest. We use the US real interest rate for our study assuming a full mobility of investment fund within the international financing market. As shown in Table A2, the real interest rate in the US is 4 percent corresponding to the nominal interest rate of 6 percent and the inflation rate of 2 percent.

Debt-asset Ratio

The ratio of debt to assets is sometimes referred to as the financing structure. As already noted, the impact of this ratio on the effective tax rate is related to the expected inflation rate and (real) interest rate. For a given inflation rate and real interest rate, the higher the debt-asset ratio, the more the potential benefit from the tax deductibility for debt financing cost, or interest expenses. A higher debt-asset ratio may thus reduce effective tax rate through lowering the real after-tax cost of financing. For simplicity, we apply a debt to assets ratio of 40 percent across sector and across border in our study.

Economic Depreciation

The economic depreciation rate interacts with the tax depreciation allowance to affect the effective tax rate. Under our assumption of full mobility of capital and technology, a given type of machinery is depreciated at the same economic rate everywhere around the world. Investment in this given type of machinery will incur a higher or lower effective tax rate in those countries that provide a lower or higher tax depreciation allowance, and hence may be discouraged or encouraged in these countries.

Capital Structure

A real capital investment generally involves two categories of capital: depreciable and non-depreciable assets. These two categories can be further divided into four types: buildings and machinery, both depreciable, and non-depreciable items, such as inventory and land. Capital investments in different industries are as a rule structured differently.

Moreover, under the same statutory tax rate(s), different types of assets may incur different effective tax rate due to the various interactions between tax provision and non-tax parameters discussed above. In the absence of other information, we use the same capital structure by industry, based on the Canadian data, to aggregate these differentiated effective tax rates on various types of capital for a given industry across countries. But for domestic METR analysis performed for Jordan, capital structure for mining, hospitals and hotels are estimated based on firm data obtained from ITD.

Table A.1: Non-Tax Parameters for FDI Host Countries (%)

	Jordan	Ireland	Tunisia	Egypt	UAE/Dubai	Israel
Inflation rate[67]	2.3	4	2.7	2.7	2.1	2.5
Interest rate[68]	6.3	8	6.7	6.7	6.1	6.5
Debt to assets ratio						
Debt raised abroad to home capital	40	40	40	40	40	40
Debt to assets ratio in home country						
Manufacturing	29	29	29	29	29	29
Services	38	38	38	38	38	38
Economic depreciation rate						
Manufacturing						
Buildings	3.8	3.8	3.8	3.8	3.8	3.8
Machinery	16.4	16.4	16.4	16.4	16.4	16.4
Services						
Buildings	3.5	3.5	3.5	3.5	3.5	3.5
Machinery	24.4	24.4	24.4	24.4	24.4	24.4
Capital structure by asset type						
Manufacturing						
Buildings	23.8	23.8	23.8	23.8	23.8	23.8
Machinery	47.2	47.2	47.2	47.2	47.2	47.2
Inventory	27.7	27.7	27.7	27.7	27.7	27.7
Land	1.3	1.3	1.3	1.3	1.3	1.3
Services						
Buildings	48.4	48.4	48.4	48.4	48.4	48.4
Machinery	16.6	16.6	16.6	16.6	16.6	16.6
Inventory	22.8	22.8	22.8	22.8	22.8	22.8
Land	12.2	12.2	12.2	12.2	12.2	12.2

Notes

Unless otherwise specified, all the numbers are obtained from the International Tax Program, University of Toronto, based on its estimate for multinational companies.

[67] Based on IMF, International Financial Statistics. The estimate is the annual change in consumer price index from 2002 to 2003 except for Israel and UAE. For Israel, owing to the unusually high inflation rate in 2002, this estimate is an average annual change in CPI for 1997-2003. For UAE, due to the lack of latter data, the estimate was for 2001.

[68] Considering capital mobility, we assume a real interest rate of 4 per cent for FDI in *all* host countries. This assumption is made based on the financial indicators published on The Economist, April 17th-23rd.

ANNEX 7: TAX AND INCENTIVE SYSTEMS IN COMPARISON COUNTRIES[69]

This annex presents an outline of business taxation in Ireland and in the four countries that Jordan competes with directly for foreign investment: Tunisia, Egypt, the United Arabic Emirates, and Israel.

This outline covers three major tax components: the capital tax provision, which describes how the income from capital investment is taxed, the transaction taxes[70] that may affect the cost of capital goods, and the tax incentives that are intended to attract capital investment in the country. The data for each of these components is summarized in the table below.

Table A.2: Business Tax Provisions Applicable to Manufacturing and Service Industries

	Jordan	Egypt	Israel	Tunisia	UAE/Dubai	Ireland
Capital Taxes						
Company income tax rate	15/25/35	34.0/42.0	36.0	20.0/35.0	0-55	12.5
Other income/Revenue-based tax	Yes	None	None	Yes	Yes	None
Tax depreciation Rate[71]						
Buildings	2.0-4.0 SL	2.0 SL	2.0-8.0 SL	5 SL	4.0 SL	4.0 SL
M&P - Manufacturing	15.0 SL	15.0 SL	7.0-20.0 SL	10 SL	15.0 SL	15.0 SL
M&P - Service	17.5 SL	15.0 SL	6.0-20.0 SL	17.5 SL	15.0 SL	15.0 SL
Loss Carry-forward	Indefinitely	5 years	Indefinitely	Indefinitely[72]	Indefinitely	Indefinitely
WH tax on dividends	None	10.0	25.0	None	None	20.0
Property tax (rental based)	15.0	30.0-32.0	NA	8.0-14.0	10.0	4.1
Property transfer tax	10.0+	5.0	Up to 5.0	5.0	4.0	9.0
Indirect Tax Rate						
Sales tax*	16.0	10	18.0	18.0	None	21.0
Import duty on M&E[73]	Up to 30.0	Up to 10.0	Mostly zero	Up to 5.0	0.0	Mostly zero
Tax Incentives						
Tax holidays	10+ years	5/10/20 yrs	7/10 years	10+10 yrs	5 years	No
Accelerated depreciation allowance	Yes	Yes	Optional	Yes	Yes	Yes
Import duty exemption	Yes	Yes	Yes	Yes	Yes*	Yes

Notes

According to the IBFD, as an investment incentive, all the capital goods imported to UAE are exempted from the import duty; according to information published at the official website of Jordan's Customs Department, import duty is zero on all goods imported to UAE. Despite the inconsistency, both sources indicate an effective zero import duty on M&E.

* As noted in the body of the report, information on value-added tax is provided for comparative purpose only, since (in theory) it should not have any impact on capital investment.

7.1 Ireland

Capital Tax Provisions

Corporate Income Tax Rate

The standard rate of corporation income tax for trading income is 12.5 percent. A special rate of 25 percent applies to profits from non-trading, or "passive" income including rental income, interest income, royalty income and dividends from foreign companies. As an incentive to encourage manufacturing and certain types of services[74], a lower rate of 10 percent was introduced in 1981.

[69] Unless otherwise specified, this outline is written according to the information on each of the five tax regimes published by IBFD.

[70] For comparative purpose, information on value-added tax is provided in this annex even though, theoretically, value-added tax should not have any impact on capital investment.

[71] As the classification of depreciable assets varies by country, please refer to the text for details. DB = declining-balance method, and SL = straight-line method.

[72] For deferred depreciation in loss years only. Other operating losses may be carried forward for 4 years.

[73] The import tariff shown in this table is adopted from "tariff schedule" provided by Jamal at the AMIR, Jordan. According to International Bureau for Fiscal Documentation, the effective import duty for machinery and equipment in Egypt is a flat rate of 15%. See Annex 7 for details.

[74] According to Price Waterhouse Coopers (2003), these services comprise the following: financial services for non-residents within the Customs House Docks Area, repairs to ships, certain activities conducted at Shannon Airport,

However, this lower rate expired for qualifying activities that commenced on or after July 23, 1998, and will expire at the end of 2005 for any qualifying activities carried on in the International Financial Services Centre (IFSC) located in the Customs House Docks Area (CHDA) and Shannon Free Airport Zone (SEAZ). Only those qualifying activities that commenced before July 23, 1998 can enjoy the incentive rate until the end of 2010.

Depreciation Allowance

The depreciation system is relatively simple, and straight-line depreciation is used for all types of assets. There are two major categories of depreciable assets.

- plant and machinery including motor vehicles, and
- broadly defined industrial buildings including airport buildings, hotels, etc. However, certain commercial buildings do not qualify for tax depreciation allowance unless they are located in a tax incentive area for a defined period.[75] The allowance for plant and machinery is 12.5 percent and that for industrial buildings 4 percent.

Other major depreciable assets may be categorized in the following fashion.

- First, capital expenditures on qualifying scientific research, whether or not related to a company's trade, enjoy a 100 percent tax depreciation allowance.
- Second, with respect to intellectual property, expenditure on trademarks may be fully deducted although not depreciable for tax purposes. Acquisitions of patent rights may be depreciated over 17 years but expenditure on goodwill does not qualify for any deductions.
- Third, plant and machinery (excluding motor vehicles) used for certain scheduled mining business may be depreciated up to 100 percent and entitled to a 20 percent investment allowance.
- Fourth, registered holiday cottages and camps, buildings used in market gardening and intensive livestock production may claim an annual 10 percent depreciation allowance.
- Finally, registered nursing homes, certain types of buildings for medical or educational use, and approved childcare facilities may be depreciated in 7 years or even faster.

Inventory Accounting Method

Inventory is valued at the lower of cost or market value. As such, the FIFO method is an acceptable method of calculation while the LIFO method is seen as inappropriate.

Loss Carry-overs

Trading losses may be carried backward for the immediately preceding accounting period on a "gross basis" or may be carried forward indefinitely. Terminal losses may be carried back three years.

Taxes on Investment Income

The withholding tax rate on dividends is 20 percent but inter-company distribution within the country is exempt from tax. A 20 percent tax rate is also applied to capital gains, interest income and royalties.

Property Tax

According to IBFD, the property taxes on buildings and land are imposed by per square meter and vary by locality. Local authorities are also empowered to levy charges on all occupiers for specific services, such as water supply.

According to KPMG's Ireland office (http://www.kpmg.ie/industries/construct/overview.html), duty on the rent is charged at a percentage of the average annual rent depending on the term of the lease, the

certain design and planning services for particular foreign construction projects, fish farming and processing, computer services, the remanufacture or repair of computer equipment by the original manufacturer, data processing, shared services, call centers, plant micropropagation, repair or maintenance of aircraft, commercial production of films within the State, and meat processing.

[75] Refer to IBFD, Ireland, pages 105-107 for details.

lowest rate is 1 percent for the lease terms up to 35 years. Rental income is also taxable in proportion to the applicable income tax rate. For rent received by a company, the tax on the rental income is 25 percent of the corporation tax rate. That is 3.1 percent with the 12.5 percent corporation tax rate. Finally, there is stamp duty on property transaction. For non-residential property, the rate is 9 percent for the property value above €150,000. This information is used for our METR analysis.

Transaction Taxes

The standard value-added tax rate is 21 per cent. However, a lower rate of 13.5 percent is available for certain services including those related to public utility, tourist services, entertainment and cultural industries, etc.[76]

There are several levies at customs on imported goods. However, capital goods including M&E imported from countries outside European Community are mostly zero-rated, noting that goods and services are duty free across borders within the European Community. (Source: The Ireland Revenue Commissioners, see http://www.revenue.ie/)

Tax Incentives

Besides the generally low income tax rates, the major incentive for encouraging capital investment consists of an accelerated depreciation allowance. The accelerated depreciation allowance may take the form of an initial allowance or free depreciation. The initial allowance is generally granted in the period in which expenditure is incurred and must be claimed up to the full amount available or not at all.

The free depreciation is granted on a claim for any period in which the relevant assets is in use for a qualifying purpose. It can be claimed at any amount between zero and the maximum amount available, which may not exceed 100 percent of the unclaimed original cost of investment. In general, initial allowances and free depreciation for newly purchased plant and machinery, excluding road vehicles, are confined to assets in use in operations qualifying for the 10 percent rate of corporation tax in the IFSC or SFAZ. Buildings for the vast majority of companies have been qualified for accelerated depreciation

7.2 Egypt

Capital Tax Provisions

Corporate Profit Taxes

The profit tax is imposed on accounting profit with certain deductible expenses. The general rate is 40 per cent. A lower rate of 32 per cent is applied on income from exporting and industrial activities.

An additional development duty of 2 per cent is charged on taxable income in excess of EGP18,000. As a result, the combined tax rate on taxable profits is 42 percent in general and 34 percent on income from exporting and industrial activities, including manufacturing, Furthermore, in the case of profits arising from export operations, only 70 percent of the profits exceeding EGP 18,000 are taxable.

Depreciation Allowance

Both straight-line and declining-balance methods are allowed for claiming tax depreciation allowances. The current straight-line rate for the tax depreciation allowance is 2 per cent for buildings and 10 to 15 per cent for plant and machinery. An additional investment allowance of 25 per cent is available for new machines and equipment in the year when they are put in use, which reduces the cost basis for the normal depreciation allowance.

[76] Refer to Price Waterhouse Coopers (2003), page 354 for details.

Inventory accounting method

Inventories can be valued using first-in-first-out (FIFO), last-in-first-out (LIFO), or average cost methods. In practice, the majority of taxpayers are use FIFO.

Loss Carry-over

Operating losses can be carried forward for five consecutive years following the loss year.

Tax on financial investment income

Dividends distributed by a resident company are not subject to withholding tax since they are paid out of after-tax profits. Other investment incomes including interest income, royalty and dividends received from abroad are taxed at 32 percent unless the recipient is a non-resident and entitled to a different treaty rate.

Capital gains are taxed as ordinary income except that gains from dealing in stock exchange securities are not taxable and losses are not deductible for tax purposes.

Property Taxes

Property taxes are assessed on the annual rental value of land and buildings. The rates of such taxes are about 30 percent generally, and 32 percent in Cairo and Alexandria.

There is also a tax on the transfer of property within the boundaries of an Egyptian city. The tax is imposed at a rate of 5 per cent on the gross proceeds, without any deduction.

Transaction Taxes

There are two main types of transaction taxes related to doing business in Egypt. One is the import duty on production inputs including capital goods and material inputs, and the other is the sales tax. The average import duty on machinery required for investment is 5 per cent[77]. The general sales tax rate is 10 per cent. The sales taxes paid on input for producing exported goods or on re-exported goods are refundable upon application.

Tax Incentives

Egypt's new Investment Guarantees and Incentives Law (Law 8 of 1997) repeals and replaces the previous Investment Law (Law 230 of 1989). The most important feature of this new law is that it allows companies, once established, to gain incentives automatically, no longer requiring the prior approval of any administrative authority. The qualification for firms to gain incentives is decided by the nature of their business, which covers a broad range of sectors from agriculture, industrial, tourism, and transportation to medical, leasing, project management, and more.

Tax holidays, or exemptions from the income tax, are granted on capital investment in Egypt in accordance with Law No. 8 of 1997, which replaced law No. 230 of 1989. The length of tax holiday varies according to the number of employees, the location of the investment, and the type of business.

The major types of tax holidays that are most relevant to our comparison are the 5-year and the 10-year tax holidays. The 5-year tax holiday is available for all industrial and commercial projects which hire 50 or more employees and maintain proper books of account. Projects located in new industrial zones, new urban communities and remote areas are exempt from tax for 10 years from the beginning of their activities. A 3-year exemption from stamp duty is also available.

On 30 August 1999, the Prime Minister issued a decree granting exporters exemption from all taxes with immediate effect. The government indicated that the exemption would also apply to companies with an independent budget for export activities. However, the government has declined to proceed

[77] The original description by IBFD (on Egypt, page 27) is the following: "The import of materials, equipment, machinery, spare parts and means of transport, to the extent that these are required for establishing and expending a project in one of the fields prescribed by the Law, is subject to customs tax at a flat rate of 5 percent of the value of the imported goods. In addition the requirement to register in the Register of Importers is waived." (Refer to IBFD, Egypt, page 27)

with these proposals on the basis that the exemption would contravene WTO provisions, which Egypt should follow as a WTO member country.

7.3 Israel

Capital Tax Provisions

Corporate Income Tax Rate

The Israeli company tax system is essentially a classical system. That is, the income of a company is first subject to the corporate income tax, and then the after-tax distributions are taxed again in the hands of recipients, regardless of their residency status. The standard corporate income tax rate is 36 percent, and the standard withholding tax rate on dividends is 25 percent. As a result, the combined tax rate on distributed income can be as high as 52 percent [=36 percent+25 percent*(1-36 percent)]. Reduced tax rates for both corporate income tax and the dividend withholding tax are available for "approved projects" under the Law for the Encouragement of Capital Investments, 1959 (see below).

Depreciation Allowance

Tax depreciation is generally carried out on a straight-line basis. The standard annual depreciation allowance is 4 percent - 8 percent for industrial buildings and 2 percent - 4 percent for other buildings. Otherwise, the annual depreciation allowance is 7 percent to 15 percent for a broad range of M&E; but a higher allowance of 20 percent is available for electronic computers, trucks, heavy equipment, etc. and a lower rate between 6 percent and 7 percent applies to furniture and office equipment.

Under the "Inflationary Adjustments Law", special rates are available for firms engaged in qualified sectors under the Law for the Encouragement of Capital Investments, including industry, agriculture, hotel operations and software production or construction. For example, business in industry may claim an annual depreciation allowance of up to 20 percent-40 percent on a straight-line basis, or 30 percent-50 percent on a declining-balance basis. The actual applicable depreciation rate depends on the number of shifts worked.

Inventory Accounting Method

Inventory is valued at the lower of cost or market value, cost being determined by the first-in-first-out (FIFO) or average methods.

Loss Carry-overs

Trading or business losses may be set off, in the year in which they arise, against income from any source (including financial income); and the balance of such losses may be carried forward indefinitely to be set off only against future business income.

Taxes on Investment Income

As mentioned above, dividends distributed by Israeli resident companies are taxable at the regular rate of 25 percent, with a lower rate of 15 percent on dividends received from "approved enterprises."

Interest is generally subject to a withholding tax of 15 percent except for interest on government bonds issued to non-residents and interest on non-residents' foreign currency bank accounts.

Capital gains are divided into "inflationary" and "real" gains, and only the latter are taxable. The tax rate is 25 percent. While non-residents are taxable only on capital gains relating to assets in Israel, residents, both corporate and individual, are taxable on worldwide capital gains.

Property Tax

Municipal property taxes and levies and other license fees are levied annually according to the size and type of building. However, no detailed information on tax rates is available at this stage.

Purchasers of real estate may be liable to an acquisition tax, or transfer fee, of up to 5 percent of the transfer value.

Transaction Taxes

The standard value-added tax rate is 18 per cent. However, a lower rate of 13.5 percent is available for certain services including public utilities, tourist services, entertainment and cultural industries, etc.[78]

Tax Incentives

Under the Law for the Encouragement of Capital Investments (1959), investment projects engaged in Israel's industrial, technological and tourism sectors are entitled to certain alternative tax incentives.

The two principal alternatives are income tax reduction and accelerated depreciation. Under the first option, approved investment projects may enjoy a reduced income tax rate of 25 percent for a period of 7 years. A further reduced income tax rate for a period of 10 years is available for foreign-owned projects, with the degree of tax reduction related to the share of foreign ownership. The lowest income tax rate is 10 percent for projects with over 90 percent foreign ownership. Alternatively, an approved enterprise may opt for accelerated depreciation for M&E at double the standard rates during the first 5 years in which the assets are operated. When the M&E are operated on additional shifts or under extremely difficult conditions, the tax authorities may grant depreciation of 250 percent of the standard rate. In the case of buildings depreciation of 400 percent of the standard rate may be claimed, but the rate is not to exceed 20 percent per annum.

As mentioned above, dividends are taxable in the hands of recipients. While the standard withholding tax rate is 25 percent, a reduced rate of 15 percent is available for approved projects during the period for which the reduced corporate income tax is available. As a result, for a foreign firm subject to the 10 percent CIT rate, the combined tax on distributed profits is 23.5 percent [=10 percent+15 percent*(1-10 percent)].

In addition, income received by a foreign entity arising from an investment in an R&D-intensive Israeli company is exempt from tax.

7.4 Tunisia

Capital Tax Provisions

Corporate Income Tax Rate

The standard rate of corporation income tax is 35 percent. A reduced rate of 20 percent is available for 5 years for companies which float at least 30 percent of their capital on the stock market prior to 1 February 2005. A much lower rate of 10 percent applies to firms carrying on handicraft, farming and fishing activities and some cooperatives[79].

There is also a minimum tax. The tax rate is 0.5 percent on total turnover but the maximum amount payable is TND 1000 for firms subject to the 10 percent CIT rate and TND 2000 for those subject to the 35 percent rate. The tax rate is 20 percent for legal entities which are wholly or partially exempt from the income tax, or 10 percent for certain companies that benefit from tax incentives under the Tunisian Investment Code.

Several other taxes are levied based on total or partial turnover. First, a tax on business activities is to be paid to the Fund for the Development of Competition in the Industrial Sector (FDCIS). The tax is one percent on turnover excluding value-added tax, and products exported are exempted from this tax. Second, a local tax on industrial, commercial and professional establishments is based on gross local turnover, including value-added tax, the consumption tax and the special levy paid to the

[78] Refer to Price Waterhouse Coopers (2003), page 354 for details.
[79] For more details on the applicability of these lower rates, refer to IBFD, Tunisia – 7.

FDCIS. And finally, there is a business training tax levied at the rate of 2 percent on the total amount of fees, wages, salaries, etc. paid during the preceding year.

Depreciation Allowance

Actual depreciation costs calculated using the straight-line method may be written off within the limits of the normal practice of the industry, business or enterprise involved. The rates of straight-line depreciation are based on the guidelines issued by the Ministry of Finance on useful life for depreciable assets. With the classification of depreciable assets streamlined recently, four major types of assets are classified and associated with the following length of useful lives: 20 years for buildings, 10 years for machinery, 5 years for furniture and office equipment, and 3 years for start-up and establishment costs. Machinery and production equipment including computer equipment and agricultural plant and machinery, with a normal life no less than 5 years, may be depreciated using the declining-balance method. The rates for using the declining-balance method are 2.5 times those for using the straight-line method.

Inventory Accounting Method

Information is not available after searching through IBFD publications and Tunisian government website and contacting accounting firms located in Tunisia. To minimize misestimate, the average cost method is assumed for our marginal effective tax rate modeling and analysis.

Loss Carry-overs

Operating losses may be carried forward for 4 years except for depreciation deferred in loss years, which may be carried forward indefinitely.

Taxes on Investment Income

Dividends and similar distributions are exempt from tax irrespective of whether the recipient is a resident or a non-resident individual or corporate shareholder. There is no withholding tax on this type of income either.

Capital gains realized by resident companies are taxed at standard corporate income tax rate while gains realized by individuals on securities are exempt from income tax unless related to a trade or a business. Gains on securities realized by non-residents are generally exempt from tax in Tunisia unless attributable to a permanent establishment or fixed base.

Interest income is subject to withholding tax at the rate of 20 percent. The withholding tax is creditable against the overall income or corporate tax payable. However, this tax is final for any legal entity exempt from the general income tax.

Property Tax

The property tax is levied by local authorities. The tax base is 2 percent of the reference price per square meter multiplied by the area of the building, which is determined every 3 years. While the reference price is classified by area, the tax rate is determined by the number of municipal services available, ranging from 8 percent to 14 percent. The tax on underdeveloped land is 0.3 percent of the actual value of the land.

There is also a duty of 5 percent on the transfer of immovable property (other than land intended for the building of a main residence).

Transaction Taxes

The standard value-added tax rate is 18 per cent, with a reduced rate of 6 percent for certain goods and services and a 10 percent rate for certain professional services and plant and machinery imported from the European Union or locally made. An increased rate of 29 percent is applicable to luxury goods.

Tunisia signed an association agreement with the EU under which a free trade zone will be progressively established by 2008 when all customs duties and similar taxes on imports from the EU

will be abolished. Note that customs tariffs applicable to manufactured products with no equivalent on the domestic market have already been removed.

Investment Incentives

The Tunisian Investment Code provides tax incentives for investment in agricultural, industrial, service and tourism sectors. The code automatically applies to resident and non-resident investors and no prior approval need be obtained before investment is made. The general tax incentive is an exemption from income tax for up to 35 percent of taxable income or profits provided that investors follow certain regulations including those with respect to accountancy, tax filing and paid-up capital.

Special incentives are also provided for export, regional development, environmental protection, information technology, etc. For exporters, the tax incentives include a full exemption from income tax for the first 10 years and a 50 percent exemption for the following 10 years, together with full exemption from customs duties and similar taxes on all imported business inputs.

7.5 United Arab Emirates/Dubai

Capital Tax Provisions

Corporate Income Tax Rate

Although the popular impression is that UAE/Dubai is a tax-free territory, corporate income is subject to taxation there. In particular, the Dubai Income Tax Decree, like its counterparts in other emirates of UAE, makes no distinction between domestic and foreign companies. The tax rate is progressive with the first 1 million AED of taxable income being taxed at a zero rate and taxable income above 5 million AED being taxed at 50 percent. However, unlike the case in other Emirates of UAE where total income is taxed by bracket at multiple rates, the total income in UAE/Dubai is taxed at a single rate, depending on the bracket in which the income falls, subject to a marginal relief. Because of this unique feature, any firm with taxable income slightly above AED 1 million, say AED 1.2 million, will have to pay a tax on the full amount of taxable income with no exemption for the first AED 1 million[80].

However, a flat rate of 55 percent applies to oil companies although concession rates are often agreed on an individual basis. On the other hand, tax levied on most foreign banks is at a flat rate of 20 percent with certain restrictions on allowable deductions. For example, general and contingent provisions are not allowed, and losses can be carried forward for only two years. These two special cases (i.e. tax treatments for oil companies and foreign banks) are irrelevant to our cross country comparison for Jordan, which is focused on FDI in manufacturing and services sectors.

Depreciation Allowance

The claim for depreciation allowance must be reasonable although there is no restriction. In the absence of proof, the official guideline is 4 percent for buildings and most structures and 15 percent for most plant and machinery including office furniture and equipment. Intangible assets may be depreciated at 10 percent and motor vehicles $33^{1/3}$ percent.

Inventory Accounting Method

Information is not available after searching through IBFD publications and UAE government website and contacting accounting firms located in Tunisia. To minimize misestimate, the average cost method is assumed for our marginal effective tax rate modeling and analysis.

Loss Carry-over

Trading losses may be carried forward indefinitely.

[80] Refer to IBFD, United Arab Emirates, Page 82, for illustration of the calculation of tax payable with "marginal relief."

Taxes on investment income

No taxes are levied on dividends paid between companies. The lack of taxation on individuals means that profits distributed to individuals are taxed only in the hands of the distributing company.

Property Tax

The Dubai municipality levies a 10 percent tax on the rental value of both residential buildings and commercial properties. According to HillTaylorDickinson, an international law firm (www.htd-law.com), there is a 2 percent tax on the price of property transferred, payable by both seller and purchaser. As such, the total property transfer tax is 4 percent based on the property price.

Transaction Taxes

A customs duty of 5 percent is applicable to all taxable goods other than those from member countries of the Gulf Co-operation Council (GCC). However, for industrial projects, duty exemption is available upon approval for plant and equipment, spare parts and raw materials during the whole life of the project, and semi-finished goods and packing materials for a 5-year renewable period.

Tax Incentives

Under the Organization of Industrial Affairs Act, approved industrial projects may enjoy a five-year income tax exemption along with other privileges. “Industrial” here means manufacturing including processing operations with certain restrictions. For example, small projects with a capital of AED 250,000 or less, employing 10 or fewer people, are not covered by this law.

There are also two free zones in Dubai: the Jebel Ali Free Zone and Dubai Airport Free Zone, which provide virtually a tax-free environment for business.

ANNEX 8: U.S. TAX AND ECONOMIC PARAMETERS

The corporate income tax (CIT) rate in the United States is 35 percent at the federal level. At the state level, the average CIT rate is about 6 percent, which is deductible in calculating federal income tax liabilities. As a result, the combined CIT rate is about 39 percent. The tax rate on interest income is 28 percent and that on equity income 31 percent, both of the latter numbers being adopted from the estimates of the International Tax Program at the University of Toronto.

The inflation and interest rates used in our model for the U.S. are 2.0 percent and 6.0 percent, respectively. Both are based on the "economic and financial indicators" published in issue 17-23 April 2004 of *The Economist*. The former is "The Economist Poll" on inflation based on the consumer price forecast for 2004 of 1.8 percent, and the latter is the latest annual interest rate on corporate bonds of 5.85 percent.

Table A.3: U.S. Tax and Economic Parameters, 2003 (%)

CIT Rate	Tax Rate on Interest Income	Tax Rate on Equity Income	Interest Rate	Inflation Rate
38.9	28	31	6.0	2.0

ANNEX 9: ESTIMATED REVENUE FROM PROPOSED CHANGES

9.1 Basic Assumptions

A 4.5 percent annual growth rate, estimated based on GDP at the current price during the period of 1998 – 2003 (refer to Ministry of Finance, Government Finance Bulletin, Vol. 6 – No.2, March 2004)[81], is applied to every aspect of our revenue estimate[82].

All the estimates are first made based on the 2001 data, the latest year available, and then "aged" into future years by applying the annual growth rate of 4.5 percent.

All the estimates are based on data obtained from Department of Statistics unless specified otherwise.

9.2 Methodology and Revenue Estimates

Revenue Loss From Exempting Import Duty for all Capital Goods

1.1: Estimate the total durable goods imported for household consumption as a share of total imported M&E[83] including durable goods (i.e. items included in Chapters 84-86 and 88-89), H_{ni}.

This estimate is arrived by an iterated simulation based on data on total investment in M&E, exempted portion of this total M&E investment including government and exempted business sectors, the output of M&E manufactured in Jordan of which we count only 50 percent as capital input, and the total value of imported M&E including the durable goods and related import duty collection. The result is 33 percent

1.2: Estimate the total business M&E investment in JD amount and as a share of total M&E import that are not currently entitled to import duty exemption, B_{ni}, the result amount is JD 177 million and the share is 34 percent

1.3: Estimate the effective import duty rate on all M&E including household durable goods covered in aforementioned chapters, T

$T = V/I$

With V = total import duty collected, and I = total amount of imported goods. The result is 4.5 percent.

1.4: Estimate the effective import duty rate on M&E by business sectors that are not entitled to the import duty exemption, $T_{m\&e}$

$T_{m\&e} = T/ (H_{ni} + B_{ni},)$

The result is 6.7 percent.

1.5: estimate total import duty collected from imported M&E, V_k,

$V_k = I_{m\&e\_ni} * T_{m\&e}$

The resultant estimate for 2001 is JD 11 million.

[81] According to *The Jordan Times*, May 17, 2004, Page 8, "Jordan's minister of finance expects the growth rate of the gross domestic product (GDP) during the current year to reach 5 percent. Some observers will think this is on the high side, but the International Monetary Fund (IMF) accepted this optimistic prediction on the understanding that the full potential of Jordan's economic growth could be 6 per cent, a rate that official economists think can be reached in the medium term, if the dust settles in the Middle East."

[82] As a reference, the average annual growth rate in tax revenue from "corporations" is 4.9 percent during the period of 1997 – 2003. This rate is 8 percent for the period of 1998 – 2003 as this tax revenue was higher in 1997 (96.5 million JD) than 1998 (84.1 million JD), which reflects the fluctuation in tax revenue from companies.

[83] M&E are those commodities included in Harmonized Commodity Description and Coding System, Chapters 84-86 and 88-89. We exclude Chapter 87 which cover motor vehicles.

1.6: Estimate total revenue loss from exempting all imported M&E for year *i*, $L_{im,}$.

$L_{im} = V_k * (1 - z \text{ percent})$

The final term in the left hand of the equation reflects the interaction between the import duty and the profit taxation, with z percent = weighted average company income tax rate across sectors that are not entitled to the current import duty exemption, which is 22.7 percent. The resultant revenue loss for year 2001 is JD 8.5 million.

Revenue Loss From Granting Initial Investment Allowance (IIA) to all Firms but Those Entitled to Current Incentive Program

2.1: The revenue loss from the IIA as if in 2001, L_{2001}

L_{2001} = y percent * x percent * (2001 M&P invested - import duty on M&P) * (1 - 49 percent)

With y percent = proposed IIA = 20 percent,

x percent = weighted average of income tax rate applicable to firms under consideration, which is 22.7 percent in this case,

2001 M&P investment = JD 276.5 million

The import duty collected on M&P = JD 8.5 million

49 percent = the proportion of total firms in tax-loss situation, which indicates that 49 percent of total IIA would not be claimed during the year when the capital investment is made.

The resultant estimate for 2001 is JD 6.6 million.

2.2: The revenue loss in year *i*, L_i

$L_i = L_{2001} * (1 + 4.5 \text{ percent})^t + \Sigma L_n$

with $n = 0 \ldots i - 1$, $L_0 = 0$, and

$L_n = (L_n / 51 \text{ percent}) * 49 \text{ percent}/5$ assuming unclaimed IIA in any given year to be written off over the next 5 years.

Revenue Gain From "No More Tax Holidays"

3.1: Equity resulted from new investment projects in year *i*, E_i

$E_i = 70 \text{ percent} * E_{2001} * (1 + 4.5 \text{ percent})^t$

With *i* = 1, 2, 3 and 4, E_{2001} = total new investment projects applied for investment incentives in 2001 (which is JD 881.4 million, based on data provided by JIB), and assuming 70 percent of new investment projects are funded by equity, which is a simple average of equity ratio for domestic investment (60 percent based on firm data provided by the Income Tax Department) and that for FDI (80 percent based on the Canadian statistics).

3.2: Revenue gains in year *i*, H*i*

$Hi = T_p * (E_i * R1 + E_{i-1} * R2 + E_{i-2} * R3 + E_{i-3} * R4 + E_{i-2} * R5)$

With T_p = weighted average profit tax rate across sectors, R1 = 5 percent, R2 = 7.5 percent and R3 = R4 = R5 = 10 percent[84], and E_{i-1} is valid only when *i* > 1 and E_{i-2} is valid only when *i* > 2, etc.

Revenue Gain From Reduced Cost of Capital

Basic assumption: a unit elasticity of capital stock to cost of capital and hence a unit elasticity of company income tax revenue to cost of capital assuming other things being equal.

4.1: percentage change in gross-of-tax cost of capital, ΔR_g

[84] Based on the firm data, the overall profit to equity ratio for manufacturing industry is about 10 percent.

ΔR_g = (current_ R_g – post_ R_g)/ current_ R_g

With current_ R_g = the overall cost of capital under the current incentive program, and post_ R_g = the overall cost of capital under the new incentive program, the resultant percentage change in cost of capital is 6 percent.

4.2: Revenue gains in year *i*, H*i*

H*i* = T_0 * (1 + 4.5 percent)^t * ΔR_g * α_i

With *i* = t = 0, 1, 2, 3, and 4, α_i = 0.2, 0.4, 0.6, 0.8, and 1 corresponding to *i* = 0, 1, 2, 3, and 4 and T_0 = the income tax revenue collected from the companies in year 0, or base year.

Revenue Loss From Firms Switching to new Incentive Program

Basic assumptions:

i) 50 percent of manufacturing firms located in Zone A will forego the current income tax reduction available to them and opt for the new incentive program.

ii) These firms are identical to the other 50 percent of manufacturing firms that are located in Zone A but currently paying income tax at a full 15 percent rate, tax data (e.g. total taxable income) for the latter are provided by the ITD and assumed applicable to the former.

5.1: revenue gain from taxing these firms under the regular rather than reduced income tax rate, G_i

$G_i = TI_{2001} * \Delta TR * (1 + 4.5 \text{ percent})^t$

With TI = taxable income for these firms during the base year (based on firm data provided by ITD), ΔTR = the difference between the full and reduced income tax rate applicable to these firms, which in our case is 3.75 percent (= 15 percent - 11.25 percent).

5.2: revenue loss from providing these firms the 20 percent initial investment allowance

L_{2001} = y percent * (2001 M&P invested - import duty on M&P) * (1 - 49 percent)

This formula is the same as that used in Procedure 2.1, and 2001 M&P invested is the statistics corresponding to these firms. The difference is that the import duty on M&P is zero since these firms are currently enjoying the import duty exemption and hence their 2001 M&P invested is net of import duty levies.

5.3, the revenue loss in year *i*, L_i

$L_i = I_{2001} * (1 + 4.5 \text{ percent})^t + \Sigma L_n$

Again, this formula is the same as the one used in Procedure 2.2 with varied statistics for I_{2001}.

5.4: net revenue loss, L_net_i, from the above revenue impacts is straightforward and can be arrived at by a simple subtraction shown below:

$L\_net_i = G_i - L_i$

ANNEX 10: PEER REVIEW

The report recommending the elimination of tax holidays in favor of broad-based incentives would have significant and very positive impact on Jordan's economy. Rather than relying on a highly-complex, unfair and distorting corporate tax system, Jordan could shift to a regime in which effective tax rates on capital investments are competitive with little if any revenue cost to the government. It would be a wise policy to pursue.

International experience suggests that these sorts of recommendation can work well. For example, Bulgaria in 1998 moved to eliminate the granting of any further tax holidays in favor of a much lower corporate income tax rate that was cut from 39 percent to 19.5 percent over time. Bulgaria now receives substantial FDI, almost 8 percent of GDP today, which is sharply higher than years previous to 1998 and above many developing countries today. Bulgaria has a winning policy.

Why would such a policy work so well? A policy in which the government no longer discriminates among industrial and commercial sectors removes it from corporate boardroom decision-making. Governments are rarely able to choose which industries are most successful but inefficient companies certainly know how to choose governments for handouts. Corporate tax holiday incentives, whereby income is exempt for a period of years, has unintended consequences:

- Tax holidays favours non-holiday investments as businesses shift profits from non-holiday to holiday investments. It also results in a large revenue loss for governments without necessarily improving the climate for investment.
- Tax benefits provided to only some businesses and not others create a non-level playing field whereby holiday companies squeeze out competitive non-holiday companies from markets, thereby having little effect on aggregate investment.
- Holiday companies cannot benefit from other incentives provided in the tax system such as accelerated depreciation and nominal interest expense deductions that provide a kick to non-holiday investments.
- Government intervention in markets that provide support for only some types of businesses creates an environment in which businesses are uncertain about the rules of the game. Political uncertainty imposes a significant cost on investments and makes foreign entrepreneurs more hesitant to enter a market.
- Companies tend to close down before the end of the holiday to move elsewhere or to extend their holiday by reappearing as a new company. Tax holidays tend to attract footloose companies rather than those willing to take a longer term view of the economy.
- Tax holidays have shown not to be as effective in attracting FDI compared to other policies such as sharply lower corporate income tax rates, investment allowances or credits and accelerated depreciation.

Governments do worry about competitiveness of their tax systems. However, as demonstrated internationally, countries attracting the most FDI – Luxembourg, Hong Kong, Netherlands, Ireland and Sweden, do so without tax holidays. Instead, many factors, including infrastructure and labor quality, as well as a low tax-rate environment without political intervention can do a lot to attract FDI on a long term basis.

The report therefore provides the Jordanian government a path for improving its tax system demonstrably to attract FDI without fiscal cost. Generally, the recommendations are sound and I would support them strongly. Income tax exemptions would be eliminated. The current import duty exemption for capital would be broadened to all sectors. A 20 percent investment allowance for machinery would be introduced. An expense deduction would be provided for small businesses, although the threshold for defining small business eligibility would need to be defined.

I have two major comments about the recommendations.

The first is that I would urge the Jordanian government to put great emphasis in the future of eliminating multiple corporate income tax rates (three rates would remain – 35 percent, 25 percent and 15 percent). Differential corporate income tax rates do not make sense in more modern economies as businesses shift income from high to low tax rate companies through financial transactions and transfer pricing. Few modern economies have multiple corporate tax rates that vary by industry. In fact, I would have put more emphasis on moving to a 15 percent corporate income tax rate for all companies rather than introducing other incentives such as the investment allowance or the small business expense deduction. It would be worth to study a Bulgarian-type reform rather than one in which corporate tax rates remain high for some industries.

The second is that great care be taken with the small business incentive. Preferential treatment of small businesses can result in the artificial break-up of companies in order to take advantage of expensing. Although one could make a case for incentives to assist small businesses with financing and to cope with a complex tax law, it would be better to reduce complexity in the tax system in general and provide a very targeted incentive, if at all, to small businesses. Expensing of capital investments is probably one of the least evils to introduce but small business eligibility must be carefully defined. I would suggest a threshold based on turnover which is more easily observable rather than assets. I also suggest very tight association rules to make sure that related companies are aggregated to determine eligibility. Otherwise, companies can easily break up resulting in substantial revenue loss to the government as well preventing companies from growing into stronger businesses to achieve economies of scale.

I believe that the technical analysis provided in the report on investment impacts, competitiveness and revenue implications is sound.

ANNEX 11: IMPLEMENTATION STEPS

The following steps should be taken to implement the recommendations presented in this report.

- Present recommendations to stakeholders. Solicit and incorporate feedback.
- Perform legal due diligence, drafting, and advocacy required to translate recommendations into law
- Provide training to Customs Department on distinguishing between capital goods imported for business and non-business purposes, as required by Recommendation 2
- Develop and publish guideline on how to identify capital goods imported for business purposes to facilitate implementation of Recommendation 2 by Customs Department
- Design and implement mechanism to resolve disputes arising from customer contests to implementation of Recommendation 2 by Customs Department
- Determine amount of expense election and define its beneficiaries, as required by Recommendation 4
- Provide training to Income Tax Department on processing of income tax returns claiming accelerated depreciation under Recommendation 3 and expense election under Recommendation 4
- Provide training to Jordan Investment Board for successful, accurate promotion of new program of investment incentives
- Conduct public awareness campaign to communicate changes in incentive program to all existing beneficiaries and potential new beneficiaries, including (but not limited to) the update Jordan Investment Board promotional materials

In addition to the suggestions for general tax reform presented in Annex 12, the following steps may be taken to improve the tax environment for business, based on observations made in the course of this study.

- Conduct public awareness campaign to promote benefits already offered under current income tax law, including training expense exemption and accelerated depreciation
- Design and implement initiative to speed GST refund process

ANNEX 12: COMPREHENSIVE TAX REFORM ISSUES

Tax reform is an ambitious undertaking, which encompasses far more than this report can suggest. In particular, it requires a comprehensive review of both tax structure and tax administration. In our opinion, the following areas should be given priority in such a review.

- Consolidating the various income or revenue-based taxes on companies, such as the existing multiple levies on business income through the income tax, university tax, and vocational training tax
- Minimizing tax evasion and improving tax administration, there would also be no harm in levying a gross receipts tax that is creditable against the income tax
- Reducing the number of company income tax rates from the current three rates to two rates, applicable to active trading income and financial income, respectively. The number of rates may be further reduced to one when conditions are appropriate.
- Reviewing and revising the allowance of operating expenses to follow international norms so as to improve the business environment and promote efficiency. For example, under the current income tax law, several business expenses including "hosting and travel expenses," expenses on marketing, and expenditure on R&D are deductible "in accordance with instructions issued by the Director and approved by the Minister." There are arbitrarily low limits on many of these categories of deductible expenses.
- Integrating taxation on business income and personal income by aligning the top marginal personal tax rate with the top marginal company rate
- Streamlining the individual income tax by eliminating the difference in taxing government, including public institutions and local authorities, employees and non-government employees. The distortion within the current tax structure is obvious as government employees enjoy more generous allowances for tax purposes than non-government employees. With a progressive scheme of income tax rates, there should be no differentiation in allowances by salaried sector.
- Establishing a fair, functional, and market-based property tax. Such a reformed property tax should be adequate to finance government services related to property value. An outcome should be that net rental income excluding property tax should be taxed as ordinary income.
- Modernizing income tax administration in both its approach, which would eliminate the excessive reward for early tax payment that was introduced in 1970s, and logistic conditions, which would involve the adoption of a tax return form that contains standardized procedures for reconciling accounting profit and taxable income and is submitted along with standardized financial statements. Development of a computerized system to process returns system at the Income Tax Department is critical to modernizing Jordan's tax system.
- Improving sales tax administration, particularly the process of refunding the business input tax credit, so as to make the sales tax a true consumption tax rather than a partial production tax, as at present. Further, any proposals to give incentives to selected interest groups by reducing or exempting GST should be avoided so as to protect the tax base for value-added tax.

The final two points, which involve tax administration, require the most urgent attention. They can and need to be dealt with immediately, even in the absence of major tax reform initiatives. As two of the world's leading tax experts have observed, "It is critical to ensure that changes in tax policy are compatible with administrative capacity."[85]

[85] Bird, M. Richard, and Milka Casamegra de Jantscher, "Improving the Administration in Developing Countries," International Monetary Fund (1992, p.1).