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# TAX ADMINISTRATION REFORMS AND FOREIGN DIRECT INVESTMENT: A CRITICAL LITERATURE REVIEW

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**Abstract**

*Taxation is important for economic development and growth. Countries face challenges of optimizing revenue collection and discharging its responsibility to the citizen. Tax administration reforms is one ways countries use to upscale revenue growth at the same time stimulate investments and economic development. Tax administration reforms is referred to as changes in tax regime and policy made by the government to enhance revenue collection and increase tax compliance rate. Tax administration reforms and foreign direct investment was examined to establish the relationship between tax administration reforms and foreign direct investments. The study was conducted through exploratory literature review. From the review, it was found that the aims of tax reforms are to increase tax base, rationalize tax rates, simplifying procedures, strengthening tax administration, enhancing customer's service, reducing cost of collection, improving business process, increase level of compliance and revenue. There is inverse relationship between tax administration reforms and foreign direct investments. Timely response and restructuring of economic reforms would inspire and stimulate economic development. The national and devolved agencies (County, States and Local) government should work in consultation and coordinated manner to foster unified economic policy.*

*Keywords: Tax Administration Reforms, Foreign Direct Investments, Tax, Aims of Tax Reforms*

## INTRODUCTION

Globally, most developing counties in the word reviewed their trade policy to attract foreign direct investments. These countries use different incentives and tax rebates to influence economic development. Magdalena and Druica (2014) reported that trade liberalization, privatization and deregulation of economy are done with a view of attracting foreign capital. They noted that measures such as tax break, favorable regulations and subsidies are developed to stimulate foreign capital inflow. Bastagli and Coady (2013) observed that Africa implemented significant trade policy since 1980s because it was aid conditionality (structural adjustment program). They argued that the principal reforms were to remove import barriers and reduction in tariffs. OECD (2008) set out conditions necessary to stimulate foreign FDI. These include but not limited to offering incentives to access the market and profit opportunity, sound legal framework, economic stability, and a well responsive labor market. Tax administrative reforms are the link in which the government initiate policy and regulatory framework to stimulate foreign direct investments. Kenya Revenue Authority (KRA) (2016) indicate that the main aim of tax modernization is to enhance customers service, reduce the cost of collection, efficient business processes, transparency in tax administration, increased tax compliance levels and increased revenue collection. The report indicates that challenges confronting tax reforms are resistance to change, inadequate resources, system vulnerability and inadequate budget. The objective of review is to establish relationship between tax administration reforms and foreign direct investment.

## LITERATURE REVIEW

Tax administration reforms has been defined by different scholars. Rao (2014) defined reforms as a process undertaken to improve efficiency of tax administration and maximize economic and social benefits that can be achieved through tax system. Gale and Samwick (2014) defined tax administration reforms as the process involving reduction of income tax rates as well as measures taken to broaden tax base. Therefore, from the definition above, we can deduce that tax administration reforms are the modernization of tax regime to realize political, social and economic benefits of the nation.

Jit and Gill (2003) reported that reasons why tax reforms are needed in the country is because taxes depend on efficiency in revenue administration. They noted that Weaknesses in revenue collection lead to inadequate tax collection. Financing of budget deficit through borrowing can cause unsustainable public debt. Shortfall in tax mobilization may shrinks resource envelope and affect government ability to implement its policies and programs. Tax policy influence environment in which international trade and investments takes place (NEPAD

– OECD, 2009). The report observed that economic development and investments in a country are largely affected by taxation. Both foreign investors and small businesses needs transparency and openness when dealing with tax issues so that they can grow and operate. And therefore unsustainable tax regime poses unfavorable business climate for both internal and external investors.

Analysis of how tax administration improvement can increase tax revenue is anchored in the concept of tax gap, tax gap is generally defined as the difference between the amount of tax revenue that would have been collected had all tax payers fully complied with their obligation under tax laws and the amount of revenue actually receipted by tax administration authority (Brondolo, Sivan, Borgue and Bosch, 2008). Tax gap is experienced in all revenue collection bodies and is a sign of inefficiency and ineptitude in tax collection process. The analysis of tax gap would indicate the difference of uncollected revenue that would be required to be addressed by policy direction. Saeed & Saeed (2011) argued that tax reforms are developed to widen tax base, proportionalize tax rate, and improving tax administration procedures. They observed that tax administration reforms are developed to reduce complexity, improve fairness and promote economic growth.

Asian Development Bank (ADB) (2016) reported that majority of economies have a unified revenue body administering both direct and indirect taxes with internal structure on functional principle and undertaking tax administration processes. The report indicate that development of information technology have presented opportunity for revenue bodies to enhance revenue collection, improve efficiency, quality of service delivery and reducing tax compliance cost. Reforms through tax modernization have contributed to expansion of tax burden, improvement of compliance and accuracy. The goal of tax reforms is to raise revenue, equity and freedom from economic burden (Dorasamy, 2011).It is an indication that tax reforms are a continuous process that respond to challenges experience during revenue administration process. Without tax reforms, the state would not find it possible to deliver development plan required for service delivery. International tax reforms are integral to domestic tax system development, tax reforms are responsibility of the government but external assistance providers can help in establishing an effective enabling environment for tax reforms, building effective policy and practice, developing individual talent, leadership and specialized technical skill (OECD, 2016). The report explain that external support should assist countries to build robust tax capacity, enabling environment, organization skills and equip them to raise revenue they need in a way that are conducive to stability, growth, good governance and fairness.

Direct foreign investments were defined by Biglaiser and De'Rouen (2006) as private capital flows which provide holding company with control over subsidiary outside home country. Simon, Ventura and Cocilio (2014) defined FDI as international investment where a residence entity in one economy seeks to obtain interest in an enterprise in another economy, while Kofarbai and Bambala (2016) define FDI as investment made to control management in an enterprises operating in a country other than of the investors, where the investors hold 10% or more of the voting stock of a foreign enterprises. From the following definitions, it is very clear that FDI are undertaken by foreign national to have a controlling interest in domestic economy. FDI inject capital flow in the economy, create employment opportunity and influence economic growth and development.

OECD (2008) reported that an increase of 1% in tax rate led to 3.7% decrease in FDI with most studies indicating a range of between 0% to 5%. FDI form the framework for economic growth and development, Magdalena and Druica (2014) observed that monetary factors such as interest rates and inflation attract FDI and fiscal factors seem to play less important role. Their report explain that not only do tax reform influence FDI, but also stimulate investment climate that cumulatively attract FDI such as Infrastructure, legal and political stability. Some countries failed to attract FDI due to unfriendly business environment and bureaucracies. Kransdorff (2010) argue that South Africa failed to attract FDI due to enormous tax burden. He indicates that taxation has considerable ability to attract foreign direct investment with 1% reduction in effective tax rate lead to 2% increase in FDI. This confirm the finding of OECD (2008).

Tax policy affects investment in that 1% increase in user capital lower investment by between 0.5% and 1%, taxes increase user cost of capital and therefore a reduction in user cost of capital would stimulate investment (United Nation, 2010). The report also indicates that 10% increase in corporate income tax lower FDI by 0.45% of GDP and extending tax holiday by 10 years would increase FDI by 1% of GDP. Further 10% drop in marginal effective tax rate would increase FDI by 3% of GDP. These analysis point to the importance of tax administration reforms on attracting FDI and the relationship between foreign direct investment and GDP. All these three variable are related to another. In Nigeria, some states attract foreign direct investment than others because of geographical advantage and policy issues (Kofarbai and Bambala, 2016). The researchers indicate countries which have a better record of doing business attract higher flow of FDI than those that do not have better record of doing business. Doing business is one of the moderating effects on stimulating foreign direct investments.

Njuru, Ombuk, Wawire and Okeri (2013) noted that poor level of private investment in Kenya has been of concern to the government and economist especially its influence on the realization of vision 2030 blue print target to scale up economic growth by ten percent. The report noted that income tax and value added tax discourage private investment. In Ukraine, the government develop a broad range of industry specific investments to foreign investors and certain industries are facilitated by the state by provision of tax incentives to stimulate investments. The incentives include VAT and customer duty exemption provided to renewable energy and sales of software product, special tax regime for agricultural products and exemption of import duty of certain equipment, material and components required for investments projects (Kvedris and Domgch, 2015)

## CONCLUSION

Foreign direct investment injects capital flow in the economy. This capital is needed in the economy to accelerate economic development, enhance job creation and improve employment condition in the country. As the government provide incentives, rebates and concession to attract foreign direct investments, stimulus should be offered after conducting cost benefit analysis to ascertain its effectiveness. Countries may lose much in terms of concession, rebate and tax holiday at the expense of revenue collection and economic developments.

From the findings it can be concluded that, the aims of tax administration reforms are broadening tax base, rationalization of tax rates, simplifying procedures, strengthening tax administration, enhancing customers service, reducing cost of collection, efficient business process, increase level of compliance and increase level of revenue. There is inverse relationship between tax administration reforms and foreign direct investments. Timely response and restructuring of economic reforms would inspire and stimulate economic growth. The national and devolved agencies (County, States and Local) government should work in consultation and coordinated manner to foster unified economic policy. Further research should be carried out on the impact of non-financial factors on foreign direct investments.

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