



**RWANDA**

**MINI-DIAGNOSTIC ANALYSIS OF THE INVESTMENT CLIMATE**

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**Foreign Investment Advisory Service  
a joint service of the  
International Finance Corporation  
and  
The World Bank**

This report has been prepared by the Foreign Investment Advisory Service (FIAS), a joint facility of The World Bank and the International Finance Corporation, in response to a request by the Minister of Finance and Economic Planning to undertake a rapid analysis of problems facing the investment climate in Rwanda. FIAS visited Rwanda in April, 2005 to undertake fieldwork underpinning the investigation and worked closely with The World Bank Private Sector Development Project, led by Mr. Antoine Munyakazi Juru.

The FIAS team interviewed a range of foreign and domestic investors from different countries and various sectors, representatives of foreign investors including chambers of commerce, foreign investor associations, accounting firms, law firms, and the donor community. The FIAS team worked closely with officials in many different ministries and agencies.

## Rwanda: Mini-Diagnostic of the Investment Climate

### Introduction

During the first decade since the end of the genocide, the Rwandan authorities have reconstituted and reformed the policy framework establishing the basis for a market-driven economy. Since then, the government has taken a further step and embarked on a second generation of reforms aimed at facilitating private sector development with international best practice. In our interviews with the public sector and representatives of the private sector it became clear that the government is committed to private sector reform and willing to do whatever is needed to promote investment, development, and growth.

The FIAS mission arrived in Kigali in midst of this bold agenda and undertook its assessment of the investment climate with a view to identifying further issues which affect private sector development either not explicitly addressed or absent from the agenda. Recognizing the previous work done by donors and others, the FIAS mission's investigation focused on the following areas: legal framework/business procedures, tax and customs (operating), the informal sector, land, and gender issues.<sup>1</sup> Input into this analysis came from interviews with public officials, private sector representatives, the donor community, as well as the results of other studies.

The remainder of the report is organized as follows: the next section offers a brief assessment of the investment climate, followed by a presentation of specific issues with recommendations for addressing them.

### I. Initial Findings

**Legal Framework.** A tremendous effort has been made in the past few years to overhaul the obsolete legal framework relevant for doing business resulting in a well advanced legal framework for private sector development and laws of high quality. Major legislative reforms have been completed or are about to be adopted including crucial business laws like the Income tax and customs legislation, the Investment Promotion Act, the Land Law and the Labor Law. In addition, the Government has a program in place to review remaining obsolete laws like the Company Act and Company Registration Act and filling gaps in the legal framework with laws on bankruptcy, concessions, e-commerce and accountancy for example. Major international treaties shall be ratified like those on arbitration.

**Judiciary.** Though courts are considered of high quality and integrity, investors complain about long court cases. In 2004, the Government reacted on the shortcomings

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<sup>1</sup> It should be noted at the outset that there are many other important barriers to growth and investment, such as inadequate or high-priced infrastructure, training and capacity issues, and costs of transportation, to name a few.

in the judiciary and launched a judiciary reform (11 new laws). Procedures were shortened, deadlines introduced and special chambers for commercial, labor and mining disputes established in the first instance (District Courts). The judiciary reform is well targeted and should have a major impact on the efficiency of the court system. Now it is time to monitor the effect of the reform program and fine tune, if necessary.

***Administrative procedures.*** Most of the administrative procedures relevant for the establishment and operation of businesses are not seen as an impediment to doing business by investors. In areas where investors face red tape, the government has identified and addressed the problems adequately.

***Start-up procedures.*** Procedures to start a business are well-designed. It takes about three weeks to incorporate / register a business with the Provincial Courts. However, the fee of RF 50,000 to register a sole proprietor and 1.2% of the initial capital (min. initial capital is RF 500,000) to incorporate a company is considerable. If the fee to notarize the Memorandum and for the municipal license is added, then the start up costs are 315 percent of income per capita comparably high. This may contribute to the high number of informal businesses. The Government plan to move the business registration from the Provincial Courts to the Ministry of Commerce to improve efficiency of the incorporation/registration procedures is welcomed and reflects best international practice. Furthermore, the licensing procedure at the municipal level is straight forward and is not considered as a problem by investors. In fact, licensing has no regulatory function in Rwanda and is actually a business tax to contribute to the municipal budget. Additionally, obtaining a Work Permit for foreign workers is straightforward and assistance is provided by RIEPA. A work permit can be obtained within a couple of days.

***Land.*** To date, the land system in Rwanda has been regulated by dual legislation under customary and written laws. The acquisition of land and site development is seen as a problem by investors. All land is state-owned and land titles are being phased in for leased land and can eventually be collateralized. A number of these issues are addressed by the new Land Law, which will be implemented this summer. Among other things, the law will provide protections for all registered landowners from ad hoc expropriation and will formalize the process of collateralizing through the titling system and cadastres registry.

***Tax system.*** The Ministry of Finance recently revised the tax code (to be in force as of mid-2005) which aimed at equity and efficiency in both direct and indirect tax regimes. This new regime rectifies many of the problems with the previous tax code through streamlined procedures, harmonization of incentives into the tax code, and lowered rates (corporate income tax) while widening the tax base (VAT). In addition, new guidelines address the issue of VAT refunds by setting out a strict timetable and procedure for the handling and adjudication of VAT refund claims. In parallel, there will be a revised set of guidelines issued for tax inspectors and a code of conduct adopted through an administrative decree, expected to take place at the same time as the implementation of

the new tax code. Although the tax regime is consistent with international best practice, some problems remain especially in the area of administration (see below).

*Customs regime.* The customs regime has been in the process of radical overhaul since mid-2004 in order to address the general problem of discretion in the system and specific problems of valuation, risk assessment, and time to clearance. All of the reforms were centered around the introduction of computerization and most importantly, implementation of ASYCUDA++. The initial set of reforms included the move to GATT-system valuation of imports (transaction value) for standardization and transparency, a new risk assessment system (with automatic channeling system based on an importer's track record and the type of shipment), and a reduction of time it takes for normal clearance to 2-3 days. In addition, to address complaints of abusive inspectors, a new code of conduct is expected to be adopted when the final version of the customs code is implemented (mid-2005). In addition to customs, problems with the importation of goods can also be attributed to clearing agents' activity and to fact that warehousing is carried out by a monopolist private firm. It should be noted that these changes are in the process of being implemented, and consequently, investors continue to perceive the customs process as a major impediment for their operations.<sup>2</sup>

## II. Unresolved Issues

The remainder of this mini-diagnostic report highlights four key areas which, in our view, need to be considered in order to improve the investment and thus to promote private sector development and sustainable economic growth.

**The four areas are:**

- 1. The extent and sources of informal economic activity, and impact on growth, are not clearly understood.**
- 2. The extent to which the effective tax burden is facilitating or inhibiting private sector development.**
- 3. Women entrepreneurs lack the capacity to take advantage of economic opportunities.**
- 4. Activation and implementation of the policy framework underpinning the investment climate is threatened by poor capacity in both the public and private sectors.**

Each issue is briefly presented along with a set of recommendations to tackle them.

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<sup>2</sup> In addition, investors are concerned about the effects of the COMESA free trade area their competitiveness in the domestic market

**Issue 1: The extent and sources of informal economic activity, and impact on growth, are not clearly understood.**

**Background**

Despite the impressive policy framework being implemented to underpin the investment climate (much of it consistent with international best practice), the policies and laws in place have done little to address the issue of informality which is a serious constraint on growth and the most pressing issue this mission has identified.

*The informal sector is the predominant form of economic activity in Rwanda.* There are an estimated 900,000 firms in the informal sector, of which about 70,000 are in the secondary sector and employ about 320,000 people (mainly in retail trade, agri-business, and handicrafts)<sup>3</sup>. This dwarfs the registered formal small enterprises, which mainly comprise micro and small firms<sup>4</sup>, and account for about 3000 firms. Of these, only 150 operate in the secondary sector, account for 18% of GDP, and employ about 3,000 people. In comparison, there are only about 400 large firms. However, large information gaps exist as the informal sector has not been adequately surveyed at the national level.

*There are high economic and social costs of informality.* When so much of production takes place outside of the regulated free market (in a parallel market) resources are diverted away from the official sector. This impedes economic growth, the rule of law is compromised, and business practices adapt to an un-regulated environment. The absence of formal and standardized procedures for informal businesses limits their scope for scaling-up. These systemic problems arise in addition to the loss of fiscal revenue as well as adding avenues for corruption. On a practical level, firms which operate in the informal sector are market-constrained (they cannot take government contracts), potentially resource constrained (they can only access finance on the informal market and cannot participate in donor-funded projects), and are likely unable to participate in capacity building programs. All of these reasons constrain informal business growth which ultimately constrains growth of the economy.

*Policies which traditionally contribute to informality.* For example, tax rates and administration can impose a significant fiscal and administrative burden on low-capacity, small enterprises. Small businesses in Rwanda with an annual turnover of less than RF 20 million (under the new tax law) are required to pay a flat turnover tax of 4 percent. There are also no incentives for informal firms to register with tax authorities as small firms are not eligible for fiscal concessions. RIEPA grants incentives to firms with capital of greater than US\$50,000 (US\$100,000) under new investment code.

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<sup>3</sup> The informal economy as a percent of GDP has been estimated at about 42 percent in Rwanda (World Bank Doing Database 2005). This is most likely a lower level estimate.

<sup>4</sup> Though there is no standard definition, micro-enterprises are generally defined as having less than 3 employees and turnover less than RF 1mn per annum; and small size firms between 3-30 employees and turnover of above RF 15mn per annum.

Another constraint could be costly and lengthy business registration. Business registration is relatively costly (RF 50,000) in Rwanda and could discourage firms from registering businesses. According to the *Doing Business 2005*, the cost of starting a business is 315 percent of income per capita. Also, since small firms in Rwanda use local inputs, they may not have an incentive to register as they do not require trade licenses.

In addition, firms that are not registered can sometimes obtain financing from microfinance institutions, which do not have collateral requirements. Many firms still do not have access to finance, possibly due to lack of collateral for bank finance, or do not have information on credit facilities. Instead, firms rely on their own funds or family contributions. The Government is planning to require microfinance institutions to mandate tax registration numbers from small enterprises in order to pull borrowers into the formal sector.

Another possible constraint could include lengthy procedures to register land (354 days on average according to *Doing Business, 2005*), which encourages enterprises to operate on informal land.

### **Recommendation**

Firms need to be made aware of the long term gains from formal activities. Policies to encourage informal sector firms to formalize should hinge on *reducing bureaucratic hurdles* and at the same time providing *incentives* to firms to move to the formal sector. The mission recommends the following course of action:

#### ***Phase 1: Determination of extent and sources of informality***

***Survey the extent of informality.*** A survey should be carried out to quantify the extent, sectoral breakdown, size, gender, and characteristics of firms in the informal sector. FIAS could provide assistance to carry out a survey.

***Undertake a study on informality.*** A comprehensive assessment should be carried out to determine the root causes of informal sector activity in Rwanda and propose concrete policy recommendations on how to shift economic activity from the informal to formal economy. This investigation should include the study of informal activities in both rural and urban areas, and the informal cross-border trade. FIAS can use its expertise in the determination of the sources of informality and how to address them.

#### ***Phase 2: Solution Design***

***Establish the institutional framework with public and private participation (a committee) to draw up the action plan and monitor the implementation phase.***

***Prepare Action Plan and timetable to implement recommendations from studies.*** The committee should feed the recommendations from the study into the development of a sector strategy with an action plan and timetable for implementation.

### ***Phase 3: Implementation of Action Plan***

***Implement Action Plan in specific areas identified as the sources of informality.***

Include the following in the implementation phase:

***Provide training on start-up and operating procedures in the formal sector.*** Capacity building should begin in parallel through training programs on procedures and regulations for operating in the formal sector. Guidance should also be provided throughout the process of formalization.

***Develop marketing centers for SME products.*** Opportunities for marketing SME products should be developed, such as developing clusters and cooperatives (such as Cottage Industries in India). This should include assistance for product and quality enhancement.

## **Issue 2: The extent to which the effective tax burden is facilitating or inhibiting Private sector development.**

### **Background**

#### **The effective tax burden, growth, and competitiveness**

Although the authorities have implemented a new tax regime designed to address problems encountered in the past, investors nevertheless complain that the effective tax burden (rates, number of instruments, administration) is heavy and is a constraint on growth. In addition, investors fear that the tax burden in Rwanda is heavier than in countries in the region, especially within COMESA which could hurt competitiveness.

#### **Taxing small businesses and growth**

Rwanda's small business tax regime is designed to account for the capacity constraints of some small businesses to comply with standard regime monitoring requirements, while allowing SMEs which do have the capacity the option to join either the standard or small tax regimes. At the same time, some SMEs complain that the burden of the small tax regime may be such that firms choose to operate in the informal sector to avoid costly financial and the administrative obligations. As the size of informal sector is reputedly extensive, it is possible that the small tax regime is a one of the factors pushing firms away from the formal sector.

### **Recommendations**

- ***Conduct a study of the effective tax burden by sector (qualitatively and quantitatively) to assess the relative burden within Rwanda and then compared to competitor (including COMESA) countries.*** The results of the study will provide input into the tax policy debate and will allow the authorities to assess the relative tax and incentive packages in each of the key sectors of the economy and to determine the effectiveness of each package to investment and private sector development in the country as a whole.
- ***Simultaneously, conduct a study of the effective tax burden on small businesses (the small business regime) to assess the relative burden of small business versus the standard regime.*** On the basis of these results, the small business regime can be reviewed and an assessment can be made about whether this system encourages or discourages firms to join the formal sector.

### **Issue 3: Women entrepreneurs lack the capacity to take advantage of economic opportunity**

#### **Background**

The authorities have made great strides towards resolving gender issues in the investment climate. The legal framework in place supports women entrepreneurship. That is, from a perspective, Rwandan women and men have equal access and control over productive resource such as land (*1998 Property Law, 1999 Law on Succession, draft Land Law Section 4 Articles 33-37*). Women entrepreneurs can obtain financing through the Popular Bank for women, credit union institutions, micro-credit institutions, and commercial banks.

At the same time, with an illiteracy rate of 53%, the majority of women entrepreneurs (especially in rural areas) lack the skills to manage credit. They lack the technical expertise to establish enterprises or write a sound business plan which is essential to access commercial loans. This lack of capacity affects **women entrepreneurs' competitiveness**. Second, enterprise support institutions such as the *Association des Femmes Entrepreneurs* in Rwanda lack the capacity to reach women entrepreneurs in rural areas and assist them with the necessary and specific services they need.

In addition, women do not have an entrée into domestic and international networks. Such networking structures are essential to obtain information, technology, and raw materials necessary for the development and expansion of enterprises.

#### **Recommendations**

- *Within the survey on informality (see issue 1), use gender-disaggregated data to target policy recommendations towards moving women to the formal sector;*
- *The findings of the informality survey could be fed into an assessment of training needs;*
- *The results of the needs assessment could then be used to develop a program to build capacity for women entrepreneurship.*

#### **Issue 4: Activation of the policy framework underpinning the investment climate is threatened by poor capacity in both the public and private sectors**

##### **Background**

The lack of capacity in all but the top levels of government and the private sector threaten the ability to implement and activate the policy reforms. The policy framework underpinning private sector development, such as the legal system, the tax and customs codes, and the land code has been or will shortly be in place. At the same time, if these framework improvements are not “activated” and implemented relatively quickly, their impact will be minimal in stimulating investment and growth in the economy. Such a blockage would not be due to a lack of will by the government per se.

As the authorities go further into the reform process, the degree of complexity of legislation and procedures increases substantially. Consequently, the level of capacity needed to implement these laws rises commensurately. For example, in order to fully implement the new land law, Rwanda would need to draw up a master plan for the whole country which would require expertise and resources that appear not to be available at present. Thus, implementation is stalled and as a result, this crucial component of the reform process is at risk. Second, the intellectual property law, which is consistent with international best practice, is unlikely to be implemented unless the legal capacity in the country is built up substantially.

##### **Recommendation**

*In order to bridge the gap between policy framework and implementation, the government needs external assistance to build sufficient capacity in both the public and private sectors to implement the reform agenda.* Groups such as the IFC’s Africa investment climate facility for capacity building (PEP-Africa) could provide such long term, on-the-ground assistance for both the public and private sectors

**Rwanda: Mini-diagnostic of the Investment Climate  
Matrix of Policy Recommendations**

<b>Issue</b>	<b>Recommendation</b>
<p>1. The extent and sources of informal economic activity, and impact on growth are not clearly understood.</p>	<p><b>Phase 1: Determination of extent and sources of informality:</b></p> <ul style="list-style-type: none"> <li>- Survey the extent of informality</li> <li>- Undertake a study on informality</li> </ul> <p><b>Phase 2: Solution Design</b></p> <ul style="list-style-type: none"> <li>- Establish the institutional framework with public and private participation (a committee) to draw up the action plan and monitor the implementation phase</li> <li>- Prepare Action Plan and timetable to implement recommendations from studies</li> </ul> <p><b>Phase 3: Implementation of Action Plan</b></p> <ul style="list-style-type: none"> <li>- Implement of Action Plan in specific areas identified as the source of informality</li> <li>- Provide training on start-up and operating procedures in the formal sector</li> <li>- Develop marketing centers for SME products</li> </ul>
<p>2. The extent to which the effective tax burden is facilitating or inhibiting private sector development is unknown.</p>	<p>Conduct a study of the effective tax burden by sector (qualitatively and quantitatively) to assess the relative burden within Rwanda and then compared to competitor (including COMESA) countries.</p> <p>Simultaneously, conduct a study of the effective tax burden on small businesses (the small business regime) to assess the relative burden of small business versus the standard regime.</p>
<p>3. Women entrepreneurs lack the capacity to take advantage of economic opportunities.</p>	<p>Within the survey on informality (see issue 1), use gender-disaggregated data to target policy recommendations towards moving women to the formal sector.</p> <p>The findings of the informality survey could be fed into an assessment of training needs.</p> <p>The results of the needs assessment could then be used to develop a program to build capacity for women entrepreneurship.</p>
<p>4. Activation and implementation of the policy framework underpinning the investment climate is threatened by poor capacity in both the public and private sectors.</p>	<p>External assistance to build sufficient capacity to implement the reform agenda.</p>

