

TAX AND DEVELOPMENT

PRINCIPLES TO ENHANCE THE TRANSPARENCY AND GOVERNANCE OF TAX INCENTIVES FOR INVESTMENT IN DEVELOPING COUNTRIES

Background

Many countries, developed and developing alike, offer various incentives in the hope of attracting investors and fostering economic growth. Yet there is strong evidence that calls into question the effectiveness of some tax incentives for investment, including in particular tax free zones and tax holidays. Indeed, ineffective tax incentives are no compensation for or alternative to a poor investment climate and may actually damage a developing country's revenue base, eroding resources for the real drivers of investment decisions - infrastructure, education and security. There is a significant regional competitiveness dimension too, as governments may perceive a threat of investors choosing neighbouring countries, triggering 'a race to the bottom' that make countries in a region collectively worse off.

Key Facts:

- Incentives ranked 11th out of 12 location factors in a survey of 7000 firms in 19 African countries. (UNIDO 2011). The most recent Investor Motivation Surveys in Tanzania, Rwanda, Uganda, and Burundi show that over 90 percent of investors would have invested even if incentives were not provided (WBG 2013).
- In South East Europe investors indicate that rather than encouraging FDI, special tax incentives either were not taken into account or operated to discourage investment - provisions were difficult to track, understand or comply with and/or invited corrupt behaviour on the part of tax officials, tending to increase project costs and uncertainty (OECD 2007).
- In 1980 no low-income Sub-Saharan African country had tax free zones, 50 percent did so by 2005; in 1980 about 40 percent offered tax holidays, by 2005 over 80 percent did so (IMF 2009a).
- Forgone tax revenues ranged between 9.5 and 16 percent of GDP per year in the Eastern Caribbean Currency Union over 2001-2003, while the effect of tax incentive regimes on foreign direct investment appeared to be very modest (IMF 2008).
- A study of 40 Latin American, Caribbean and African countries for the period 1985-2004 showed that there is no effect on total investment or economic growth due to tax incentives (IMF 2009b). Similarly, an empirical study of 12 Western and Central African countries over the period 1994-2006 showed no relationship between tax holidays and investment (Van Parys and James 2010).
- Dramatic turnarounds are possible. For example, prior to 2006 Mauritius had an extensive set of tax incentives. A major tax reform was undertaken in 2006 which included the removal of most tax holidays, exemptions and investment tax credits. FDI and Corporate Income Tax revenue experienced strong growth since the reforms (IMF 2011).
- The \$1.1 billion granted in tax exemptions in Tanzania in 2012 was the same amount Tanzania borrowed from China to build a 500 km gas pipeline (FT 2013).
- Morocco is the only MENA country to elaborate a Tax Expenditure Report, which has been integrated into the government's budget process (OECD 2008).

Tax base erosion due to tax incentives is compounded by the lack of transparency and clarity in the provision, administration, and governance of tax incentives. The granting of tax incentives for investment is often done outside of a country's tax laws and administration, sometimes under multiple pieces of legislation. The design and administration of tax incentives may be the responsibility of several different Ministries (e.g., finance, trade, investment). Where various Ministries are involved, they may not coordinate their incentive measures (tax and non-tax) with each other or the national revenue authority, with the result that incentives may overlap, be inconsistent, or even work at cross-purposes. Administrative discretion in the management of incentives can seriously increase the risk of corruption and rent seeking.

Despite the widespread use of tax incentives for investment, in general there is inadequate analysis of their costs and benefits in a national context to support government decision-making. There is limited data collected on granted tax incentives, qualifying investments made, direct (and indirect) benefits to the host economy, and the cost of these tax incentives in terms of foregone revenue. Moreover, even information that should be more readily available – lists of tax incentives and beneficiaries – is not always collected or reported.

Often missing from the discussion on tax incentives and their harmful effects are the unintended and unforeseen tax-planning opportunities that tax incentives and preferential tax treatments create. As the studies discussed in the box above indicate, tax incentives offered in developing countries result in little additional investment; most investors would have invested without the offer of tax incentives. Even when targeted at new investors, tax incentives are always sought by businesses outside the target group. Existing firms attempt to reconstitute themselves as “new” ones towards the end of their holiday periods so that they can continue to be tax-exempt. Similarly, tax incentives enable opportunities for profits and deductions to be artificially shifted across entities with different tax treatments either domestically or internationally. These tax planning opportunities are commonly exploited by both developed and developing countries; however, their ill effects are especially pronounced in developing countries that have limited capacity to detect and counter the detrimental tax avoidance techniques.

These challenges are gaining recognition, particularly in the context of the growing acknowledgement of the importance of mobilising domestic financial resources for development. Several countries, including some developing countries, are making efforts to assess, evaluate, and report foregone revenues as part of tax expenditure reports (which are linked to national budget processes). Internationally, there is an emerging consensus on the need to address the potential downsides of tax incentives for investment. The need is particularly pronounced today as many OECD donor governments, with generally weaker public finances than in the past, are increasingly looking to developing countries to better manage their revenue potential.

The importance of addressing the governance of tax incentives was raised in 2011 by the IMF, OECD, UN and World Bank in their joint report to the G-20 on supporting effective tax systems in developing countries (G20 report 2011). For its part, the OECD's Task Force on Tax and Development has identified the need for a more effective global transparency framework for tax incentives for investment -- the purpose of which is to promote transparency in decision-making processes, increase the information available on costs and benefits, to limit discretion and increase accountability. The development of a proposed set of principles (below) is the starting point in an international effort to promote the management and administration of tax incentives for investment in a transparent and consistent manner.

The Principles

Action is needed by governments to:

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

Tax incentives should only be granted in accordance with a comprehensive policy, which lays down principles and policy objectives for the introduction or continuation of a tax incentive. Governments should provide a justification for tax incentives (e.g. regional/territorial development, employment creation) with the expected costs and intended benefits. This should be communicated publicly through a regularly updated statement. Such a statement provides the basis for the assessment of the performance of tax incentives, any overlap and duplication and allows for governments to be held accountable for the tax incentives they have granted.

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

Tax incentives for investment are currently provided through tax laws (e.g., income tax law), but in many cases are also provided by laws governing investment, Special Economic Zones, etc. and in other cases, through decrees, agreements and regulations. As a result their true extent may be hidden. All tax incentives provided, along with their eligibility criteria, should be consolidated and publicised in the main body of tax law. Bringing tax incentives into the tax laws (or mirrored in the tax laws) increases transparency and may empower the tax administration to administer them. Those tax incentives that are used should be as simple as possible to both apply for and administer.

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

All tax incentives should be placed under the authority of one government body, ideally the Ministry of Finance. Currently, the granting and administration of tax incentives may be the responsibility of finance, trade, investment or other ministries, increasing the risk of corruption and rent seeking. Consolidating them under a single body increases transparency, helps to avoid unintended overlap and inconsistencies in incentive policies, limits discretionary power and enables policy makers to address problems that may arise with the governance of tax incentives. In countries where the granting and administration of tax incentives is decentralised and/or carried out by both the central and sub-national governments, to the extent possible, various levels of government should coordinate to maximize the efficiency and transparency of their efforts.

4. Ensure tax incentives for investment are ratified through the law making body or parliament.

Tax incentives provided through executive decrees or agreements when not scrutinized by the law making body do not provide sufficient transparency in their granting and operation. Parliamentary oversight, or its equivalent, is fundamental to transparency and accountability in the governance of tax incentives. This ensures incentives are subject to scrutiny on their intended purpose and their costs as well as benefits to the country.

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

Once provisions have been enacted in the relevant tax laws and regulations, tax incentives may be claimed by a taxpayer by meeting the necessary conditions as prescribed, without negotiating with any granting authority, except as provided for under the relevant tax laws. A minimum necessary condition to be met by taxpayers in the case of a tax incentive should be the requirement to file a tax return in the case of VAT and Income Tax, and in the case of other taxes a statement detailing the duty or other exemptions availed in the prescribed period. In addition to enhancing transparency, such taxpayer information contributes to data for determining the efficiency and equity of tax incentives. Tax authorities should also periodically carry out audits of cases where tax incentives have been claimed to ensure that they are not misused.

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

The amount of revenue loss attributable to tax incentives should be reported regularly, ideally as part of an annual Tax Expenditures Report (covering all main tax incentives). While cash expenditure budgets are usually scrutinised on a yearly basis, the revenue cost of tax incentives is hidden when estimates of revenues forgone are not calculated and reported. Embedding estimates of revenues forgone by tax incentives in the yearly budget process provides policy makers with the required inputs on a timely basis to inform policy decisions. It also supports medium term fiscal planning as what seems like a small amount of foregone revenue in good fiscal times may become quite high during periods of fiscal strain. The calculation of revenue forgone should recognise that the benefits of some investments, mineral extraction, for example, may take many years to realise so losses should be assessed over the life of the business concerned.

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

Once granted tax incentives usually remain in laws unless revoked or introduced with a 'sunset clause'. Hence there is a need to assess performance on a regular basis. Performance reviews may be conducted once every few years and would include the costs as well as the benefits of the tax incentive and if it has met its intended goals. The results of such periodic reviews would inform decision-making around the continuation or removal of individual tax incentives. The review criteria and results should be reported publicly. To the extent possible, behavioural responses, both good (e.g., additional incremental investment) and bad (e.g., aggressive tax planning) should be tracked and communicated.

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

It may be possible that a few investors, or sectors, benefit from most tax expenditures. The tax expenditure statement should have sufficient detail to enable policy makers to identify which sectors benefit from specific tax provisions and, where this is compatible with the requirement of laws and regulations governing taxpayer confidentiality, authorities may wish to consider detailing the major beneficiaries and the amount by which they benefit from tax incentives. Making such information public can enhance the legitimacy of governments and their revenue authorities in the eyes of citizens which in turn can enhance compliance more broadly.

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

Analysis of tax incentives is data intensive – required for public statements, budgeting, periodic reviews, tracking of behavioural responses by business, etc. There is a need for the periodic collection of taxpayer data and on-going analysis of these data by revenue authorities. This may require introducing mechanisms to do so in some countries.

10. Enhance regional cooperation to avoid harmful tax competition.

In many cases tax incentives are provided in response to what neighbouring countries and competitors are offering or perceived to be offering. Hence the issue of tax incentives cannot be tackled in isolation. Governments can work together on a regional basis to increase cooperation in the area of tax to avoid a race to the bottom when they provide competing tax incentives. Efforts to enhance regional cooperation should also cover the use of non-tax instruments e.g., cash subsidies and loan guarantees which also provide incentives for investment.

Stakeholder Roles and Responsibilities

In addition to governments, other stakeholders have responsibilities.

Action is needed by business to:

Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to taxation, financial incentives, or other issues.

It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate. Complying with the spirit of the law means discerning and following the intention of the legislature. (OECD Guidelines for Multinational Enterprises).

Action is needed by civil society to:

Draw attention to, and publicise, revenues forgone from wasteful tax incentives that could free up resources for development.

Civil society also has a role in promoting tax payer education so that an informed debate can take place on tax policy in general, and tax incentives management and transparency in particular.

Action is needed by development partners and donors to:

Include tax incentives and revenues forgone in the dialogue with governments in developing countries and provide appropriate technical advice and assistance.

International assistance providing countries and organisations should provide technical and other assistance to build the capacity of developing countries to collect and analyse the data required to enhance the transparency of tax incentives for investment (including micro-simulation modelling capacity).

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