actionaid

Give us a break: How big companies are getting tax-free deals.

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Front cover image:
"It is a disgrace, that there is a huge need for teachers like myself, but no public funds to pay us. Eventually God will pay me back, what the government refuses to give us."

Jane Irungu is a volunteer teacher at a government funded school in Nairobi, Kenya. Jane is one of four teachers volunteering for 5,000 shillings ($US58) per month. Like most government-run schools in Kenya, the school lacks basic amenities. It has 650 students and just 11 teachers.

Credit: Piers Benatar/Panos Pictures/ActionAid

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Introduction

One of the main reasons developing countries are unlikely to achieve many of the Millennium Development Goals, and escape the persistent poverty that plagues even those poorer countries that achieve decent levels of economic growth, is a lack of government revenue to pay for schools, hospitals, roads and other public services. As recession in developed countries provides yet another excuse for them to renege on their overseas aid commitments, every last drop of government spending is important.

Imagine, then, what you would think if developing countries' governments were giving away hundreds of billions of dollars of this precious revenue to wealthy people in developed countries, for almost nothing in return? What if, despite ample evidence that doing so rarely has any impact on investment or economic growth, they continued and even increased this spending?

Forget the 'what if'. Every week, companies operating in developing countries receive a gift of well over two billion dollars in the form of tax incentives, exemptions from the standard tax regime that others have to follow. Supposedly to encourage companies to invest, in practice these incentives subsidise profitable investments that in most cases would have been made anyway, and some even 'crowd out' local investors. Tax incentives are a product of faulty economic logic, poor policymaking and sadly sometimes corruption that has pitted developing countries against each other in a downward spiral of tax competition.

If just the incentives that exempt companies from corporate income tax were cancelled tomorrow, already enough revenue would be freed up to put every primary school aged child in school, meet all the health-related Millennium Development Goals, and leave enough change left over to invest in the agricultural programmes needed to end hunger. This paper combines new research with existing case studies to show what ending unnecessary tax incentives could do.

Tax incentives: the basics

A tax incentive (also known as a tax break) is, in essence, a special tax deal given to a company to encourage it to invest. In this section we'll introduce some examples of tax incentives uncovered by ActionAid, to demonstrate how each works.

Generalised incentives

These are incentives hardwired into the corporate tax regime, designed to make investment a more attractive prospect. A common example is 'accelerated depreciation', which allows investors to write off the cost of capital expenditure against their taxable profits more quickly than they might normally do. Although in theory a company won't pay any less tax in the long term as a result of such an incentive, in practice it can be exploited by tax planners.

Targeted statutory incentives

These apply to companies that meet certain criteria, generally because they are operating in a sector that the government wants to encourage, are producing for export, or are located in a particular area, particularly special economic zones.

Earlier this year, ActionAid UK showed how British-controlled Zambia Sugar took the Zambian government to court to win the right to benefit from a different kind of incentive. Although three quarters of its income was derived from industrial sugar manufacture, it persuaded the court in 2007 that its whole income should be classified as 'farming'. This qualified it for an incentive that reduced its corporate income tax rate to 15% (10% since October 2012) compared with a normal rate of 35%, an estimated loss to the Zambian government of US$3.6 million per year in future years.[1]

Some of these incentives apply for a fixed period of time at the start of an incentive – so-called 'tax holidays'. For example, Ghana offers agricultural processing companies a five-year holiday from corporate income tax, while companies operating in free zones (which include for instance, subsidiaries of the huge food multinationals Cargill, ADM, Barry Callebaut and Nestlé) may benefit from a ten-year holiday.[2] Free zones account for almost three-quarters of Ghana's forestry turnover.[3]

In addition to reductions or exemptions from corporation tax, special economic zones often offer companies exemptions from withholding taxes on payments abroad and trade taxes on imports and exports.

Discretionary incentives

These are specific to a particular investor, and are negotiated between the company and the government, and generally only available to large multinational investors, putting domestic businesses at a distinct disadvantage. Many of the most unfair examples are found in the contracts negotiated between governments and investors in the extractive industries (oil, gas and mining). For example, in 2011, ActionAid Sweden revealed the outrageous terms of the tax incentive negotiated between the government of Tanzania and

PanAfrica Energy, a Jersey-based company created with the support of the Swedish government-owned Swedfund, as part of a joint venture to exploit Tanzania's Songo Songo gas field. Although the Tanzanian State Development Corporation receives less than one fifth of the joint venture's profits, it agreed to pay 100% of its corporate income tax, exempting PanAfrica Energy from its tax bill for 25 years.[4]

Discretionary incentives may be granted by tax or investment promotion officials, or by politicians. The large sums of money involved mean that many of these incentives are negotiated in opaque and unaccountable circumstances. Many are kept confidential, away from parliamentary or public scrutiny.

The worst kinds of tax incentives

Some tax incentives are more harmful and less justifiable than others. Here are some types of exemption that we believe should be steered clear of at all costs:

1. Discretionary incentives. Negotiated behind closed doors, vulnerable to corruption and vested interests, these deals distort the market in favour of those investors with the most political influence.

2. Tax holidays. Tax incentives that apply for a fixed period of time at the start of an investment attract footloose investment that often moves on once its preferential terms end, rather than making the kind of long-term commitment that brings new skills, technology and links to the local economy. Alternatively, they distort investment decisions, encouraging short termism, and can lead to 'churning', where businesses continually close down and reinvent themselves under a different name or corporate entity to benefit from a new tax holiday.

3. Free zones. Businesses may well be attracted by the infrastructure, business support and proximity to other firms that can be offered in dedicated economic zones. But tax incentives here are unnecessary, and they encourage businesses to stay within the 'bubble', reducing interaction with domestic businesses that would otherwise benefit from forward and backward linkages.

4. Stability agreements. Some foreign investors benefit from special agreements that insulate them from future changes to the tax regime. While domestic businesses have no option but to comply with future changes that might increase their tax bills, these investors get to stick with any special terms they negotiated, as well as the tax rates at the time they invested, for decades if not permanently. This means that future governments for generations to come are locked in by governments at one point in time, in spite of changes to the economic situation or evidence about the success or failure of the tax policies concerned.

The rise and rise of tax incentives

Developing countries are, according to a recent IMF working paper, locked in a 'partial race to the bottom' over tax incentives.[5] On average, a canny investor obtaining the most generous incentives in a developing country was able to score an effective corporate income tax rate of 5% in 1996, but this had fallen to close to zero ten years later. The most significant competition was in Asia, whose average best effective rate was the least generous at 10% in 1996, but which fell so much that by 2006 it was negative![6]

Table 1 shows the disturbing growth in the use of tax incentives across sub-Saharan Africa over a longer period of time. The majority of countries now offer tax holidays to investors, as well as a set of benefits under an investment code. Free zones, which barely existed in 1980, are now used by half the region.[7] Worse still for public finances in African countries, this tax incentive giveaway has been accompanied by a further reduction in statutory corporation tax rates: between 1980 and 2005, the average rate in sub-Saharan Africa declined from 40% to 33%, a huge reduction in real terms.

Table 1: The proliferation of tax incentives in sub-Saharan Africa

Type of investment tax incentive	Proportion of countries offering incentives in...	
	1980	2005
Tax holidays	45%	69%
Reduced CIT rates	10%	51%
Investment allowances	59%	56%
Incentives for exports	10%	28%
Free zones	3%	46%
Investment code	31%	74%

Source: International Monetary Fund[8]

The revenue lost through tax incentives

Only a few developing countries publish 'tax expenditure' reports detailing the tax revenue given away through incentives for particular people, companies or behaviours. Indeed, in many countries it seems that even the government itself is not aware how much revenue is foregone, which of course means it cannot have assessed the costs and benefits of its policies.

Where figures are available, they demonstrate the scale of the incentive epidemic. In 2008/9 the Kenyan government gave away US$123 million in generalised investment promotion incentives, US$68 million through special economic zones, and US$120 million in incentives for exporters.[9] Bangladesh only published figures once, for 2005, which show that almost a third of the lost revenue – equivalent to 10% of the corporate income tax revenue it raises – was from tax holidays (table 2).[10]

Table 2: Revenue foregone through corporate income tax incentives in Bangladesh, 2005[11]

Type of investment	Corporate income tax foregone	
	$US million	Share of corporate income tax raised
Tax holidays	36.6	9.8%
Exemptions and deductions	38.2	10.2%
Tax rate reductions*	9.7	2.6%
Deferrals	17.7	4.7%
Tax credits	3.0	0.8%
Others*	7.9	2.1%
Total	**113.1**	**30.2%**

*The government data includes an additional US$28 million in these two categories from personal income tax, which we have subtracted assuming it is distributed proportionately between them.

In 2011, ActionAid published Rwandan government data showing that losses from tax incentives constituted a quarter of its potential tax revenue – over US$234 million.[12] In 2013, in the absence of published data from the government, ActionAid partner Malawi Economic Justice Network estimated the tax lost through exemptions by looking at a sample of company accounts. From 2008-12, it estimates that over US$300 million was foregone, almost exactly the same amount as the corporate income tax raised during that period.

Table 3: Estimated revenue foregone through tax incentives in Malawi, 2008-12

Sector	Tax foregone (US$ million)
Mining	2 902
Manufacturing	276
Retail / chains	115
Agri-processing	69
Total	**3363**

Source: Malawi Economic Justice Network[13]

To estimate the revenue lost across all countries, we started from a sample of tax expenditure reports that we could obtain, for a total of 16 developing countries, of varying sizes, per capita incomes and regions.[14] Governments vary widely in how they define, segment and calculate tax expenditures, so to be as consistent as possible we limited our analysis to exemptions from just one kind of tax: corporate income tax. The figures only refer to statutory incentives, and do not take into account discretionary ones. A sample is shown below.

Table 4: Revenue foregone through corporate income tax exemptions in sample countries

Country	Year	Corporate income tax foregone through incentives…		
		in US dollars	as a share of GDP	as a share of corporate income tax raised
16-country average			**0.60%**	**24%**
Bangladesh	2005	113,162,000	0.19%	30%
Costa Rica	2010	296,232,800	0.82%	28%
Kenya	2008	158,461,600	0.52%	21%
Mozambique	2007	154,720,800	1.93%	77%

Source: ActionAid dataset compiled from government data available online

We applied the 16-country average for revenue foregone as a share of GDP. The result is an estimate that over US$138 billion is likely given away by governments every year, just in statutory corporate income tax exemptions.[15]

Table 5: Estimated revenue foregone through corporate income tax exemptions

	Annual corporate income tax foregone (US$ billion)
Developing countries by region	
Europe and Central Asia	24.5
Middle East and North Africa	4.7
East Asia and Pacific	55.1
South Asia	13.8
Sub-Saharan Africa	7.6
Latin America and the Caribbean	33.2
Developing countries by income group	
Low	2.5
Lower-middle	29.2
Upper-middle	104.5
Total	**138.9**

Source: ActionAid calculations

These figures are just the tip of the iceberg, because they only consider corporate income tax. An East African Community report gives the cost of import exemptions for Uganda, Tanzania and Kenya to be over US$1 billion in 2008 alone.[16] On top of all this is the cost of discretionary tax exemptions, such as those reportedly benefiting PanAfrica Energy in Tanzania.

The human cost of tax incentives

The over US$138 billion that we estimate is lost through corporation tax incentives is a huge figure. It's enough to put every primary school aged child in school, meet all the health-related Millennium Development Goals, and invest in the agricultural programmes needed to end hunger.[17] But even cancelling one incentive could make a big difference:

- In Zambia, the revenue foregone in a single year from just one company – Zambia Sugar – through tax breaks, could likely cover half the entire cost of the nutritional interventions needed to tackle the country's child malnourishment.[18]
- For Tanzania, the US$10 million sacrificed to PanAfrica Energy per year could pay for the education of 175,000 girls.[19]

Case study - *Millicent, Kenya*

Millicent Ouma is the head nurse and director of Wema health clinic in Kibera, Nairobi, the largest slum in east Africa. The clinic has three nurses, a clinical officer and a part time lab technician. There are no public hospitals in Kibera, and people who live here have to rely on clinics like Wema for medical care.

"Kibera is totally neglected in terms of public service. The government does not collect enough taxes and therefore they have to prioritise where to spend money. The shantytowns are some of the losers – we lack everything in terms of health service. We do our best at my clinic, but we need more resources."

Credit: Piers Benatar/Panos Pictures/ActionAid

The cost of tax incentives extends beyond reductions in public spending. To make up for the lost revenue, governments also raise taxes on ordinary people, and even those living in poverty. In many countries, this means higher value added taxes on goods, and excise duties on fuels needed by people for lighting and cooking.

Tax incentives also corrode confidence in the tax system, damaging 'tax morale'. Small business owners faced with taxes, such as Caroline Muchanga, who sells sugar produced by Zambia Sugar, feel that the system is unfair. "Zambia Sugar should be paying more tax than us," she says.[20] In a survey of small business people conducted for Malawi Economic Justice Network, 85% said that the country's tax system was unjust, and 67% opposed incentives for foreign investors.[21] Tax morale is especially damaged by stories of influential people and companies exploiting their position to gain a tax advantage.

Is it worth the sacrifice?

The unrestrained growth in tax incentives for big business across developing countries is worrying, because there is broad agreement among policy advisers that such tax incentives are at best ineffective, and at worst damaging to domestic economic growth and to other competitor countries. In 2011, a report prepared for the G20 by the IMF, OECD, United Nations and World Bank – organisations that have in the past encouraged countries to adopt tax incentives – concluded:[22]

Incentives, including corporate income tax (CIT) exemptions in free trade zones, continue to undermine revenue from the CIT; where governance is poor, they may do little to attract investment— and when they do attract foreign direct investment (FDI), this may well be at the expense of domestic investment or FDI into some other country. Tax-driven investment may also prove transitory.

Surveys of investors illustrate the futility of many corporate tax incentives. In the World Bank's recent Investor Motivation Survey for the East African Community, 93% of investors said that they would have invested anyway, had tax incentives not been on offer; tax incentives ranked 17th, behind a host of factors including exchange rates, utility and transport infrastructure, and the other benefits of free zones: in many cases, benefits for business from public goods that can only be provided through tax revenues in the first place.[23] When researchers at the University of Nairobi asked firms their main reasons for investing in Kenya, they obtained a similar result: just 1% cited the tax exemptions available in special economic zones.[24]

There is even reason to question the value of the small percentage of investments that may be attracted by tax incentives. An IMF study published in 2009 showed that while lower statutory corporation tax rates and more tax holidays did seem to attract foreign investment into developing countries, they had no effect on total investment or on economic growth.[25]

How to end tax breaks

There are signs that some developing countries are beginning to halt the race to the bottom. Uganda's finance minister, Maria Kiwanuka, has promised to phase out tax holidays, and to eliminate discretionary tax incentives. "Investors want all-weather good roads, piped water and electricity," she said. "Government needs to provide these, but how shall we deliver such infrastructure if you are busy asking for tax exemptions? Where will we get the money?"[26] Following criticism from ActionAid Rwanda, Rwanda's 2012/13 budget announced a reduction in tax incentives projected to save it US$8 million – a good start in reducing the US$234 million total cost.[27]

While governments need to pare back the provision of tax incentives in this way, on its own it is not enough. Reduced incentives must be accompanied by two other important measures: transparency and cooperation.

First, tax incentives need to be opened up to public and parliamentary scrutiny. For example, Zambia's finance minister Alexander Chikwanda has announced that his government will review the "proliferation of inefficient tax incentives" as part of a "diagnostic review of the whole tax system" during 2013.[28]

Governments should systematically count the full cost of tax incentives through published tax expenditure reports, such as those we used to calculate the figures in this report. Reports should be published annually at the same time as the budget, to inform debate on the government's plans. They must include the revenue foregone through discretionary incentives, as well as statutory ones. At the beginning of this process, governments will also need to follow Zambia's example in conducting a full baseline audit to uncover and cost all tax incentives already in place.

Second, governments need to cooperate with each other at regional level to develop a coordinated approach to tax competition. The European Union's Code of Conduct on Business Taxation is a model developing countries could follow and improve – while the code does not counteract some serious aspects of EU members' internationally harmful tax regimes, it nonetheless sets a floor on the more harmful types of tax competition that member states will not engage in.[29] The East African Community's proposed Code of Conduct on Harmful Tax Competition is an opportunity to put in place a comparable but more robust framework.[30]

We call on all governments and parliaments in developing countries to:

- Eliminate all tax holidays.
- Publicly review all tax incentives, assessing tax expenditure (the amount of tax foregone from incentives), ensuring incentives are well targeted and commensurate with the benefits expected to citizens.
- Ensure that all phases of new incentives require parliamentary approval, and also that any new incentive offered is grounded in legislation which makes it available to all qualifying investors, foreign or domestic. This would effectively mean an end to discretionary tax incentives.
- Publish a costing and justification for each incentive offered, followed by monitoring of conditions and a tally of costs and benefits, so the public can see the impact of tax incentives.
- Grant the Finance Ministry (not solely the Investment Promotion Authority) powers over tax incentive decisions.
- Refrain from entering into stability clauses (which lock in tax incentives long term) when negotiating new tax incentives and investment agreements.
- Ensure that tax incentives are audited to check that the investment for which an incentive is offered has actually been carried out.
- Co-ordinate statutory tax incentives with groups of neighbouring countries, in order to counter tax competition.

Endnotes

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Give us a break: How big companies are getting tax-free deals
ActionAid, June 2013.