

Use and Abuse of Tax Breaks

How Tax Incentives Become Harmful

JANUARY 2020



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Introduction	2
Tax incentives for cross-border investments	4
Rationale for tax incentives	4
National and international drivers	6
Financial transparency and good governance	7
How tax incentives become harmful	8
Misused and ineffective tax incentives	8
Failure to establish basis on economic policy and strategy	9
Poor targeting of tax incentives	12
Using inefficient incentives design	14
The cost of tax incentives	14
Foregone government revenue	14
Resource allocation costs	17
Enforcement and compliance costs	17
Costs associated with corruption and lack of transparency	17
Illicit features of harmful tax incentives	20
Illicit as illegal	20
Illicit as negative impact to the economy	21
Illicit as violation of rights	21
Curbing harmful tax incentives	22
Good governance and financial transparency	22
International cooperation	23

List of Acronyms

ASEAN	Association of Southeast Asian Nations
CIT	Corporate income tax
DTA	Double taxation avoidance
ESCAP	Economic and Social Commission for Asia and the Pacific
EPZ	Export processing zone
FDI	Foreign direct investment
IFF	Illicit financial flow
IMF	International Monetary Fund
IPA	Investment promotion agency
LIC	Low income country
OECD	Organisation for Economic Co-operation and Development
SEZ	Special economic zone

Introduction

The use of tax incentives, justified on the basis that they are required to attract investments, is prevalent around the world. There is however, mounting evidence that such policies are largely ineffective and unnecessarily erode public financing for development. For the purpose of this paper, we define tax incentives as policy measures that allow deductions, exclusions and exemptions that reduce the tax liability of selected economic entities – e.g., enterprises, corporations, firms – with the intention of influencing cross-border investment behaviours, decisions or activities.¹

A report to the G20 Development Working Group in 2015 revealed that countries across all income brackets offer some form of tax incentives and that the practice has become more widespread over the past decades, especially in the Global South.² From 1980 to 2014, there has been a sharp rise in the number of sub-Saharan Africa countries offering tax holidays (rising from 40% to 80%) and preferential tax zones (0% to 50%). This trend is observed elsewhere in the Global South.

The immediate and direct effect of tax incentives is the loss of potential government revenues. Particularly in the Global South, tax incentives undermine government efforts to raise adequate domestic resources to finance the delivery of essential services and social protection at the scale and quality necessary to ensure that their citizens are able to fulfil unrealised rights, address inequality and meet the Sustainable Development Goals for all. Widespread use of tax incentives may also be linked to problems of poor governance and corruption.

Civil society in the Global South point towards the perceived link between the use of tax incentives to illicit financial flows (IFFs) and the impact on human rights.³ While tax incentives may not be illegal, many of them create complex tax structures that provide greater opportunities for tax abuse. There is no conclusive evidence that tax incentives are linked to any positive economic or social impact, especially in the Global South.

In some cases, they are offered as part of investment packages that may lead to negative social and environmental impacts, undermine good governance and increase inequality. Moreover, there is a perceptible lack of transparency in how incentives are offered and granted. These factors suggest that the use of tax incentives is an issue that should be linked to the changing landscape of the IFF definition and agenda.

Tax incentives, especially in the Global South, undermine government efforts to raise adequate domestic resources to finance the delivery of essential services and social protection at the scale and quality necessary to ensure that their citizens are able to fulfill unrealised rights, address inequality and meet the SDGs for all.

This report examines how tax incentives are, largely, unnecessary, redundant, inefficient and ineffective; and explores the role of financial transparency in curbing the rampant abuse of tax systems that undermines democracy and handicaps governments' capacity to adequately tackle inequalities and fully realise human rights for all.

We conclude that many tax incentives can be viewed as 'illicit' in nature and that clear, transparent and credible legal, technical and political processes are essential to prevent their abuse. Citizens should be given the means to know what incentives are being offered and why, to be able to hold their governments to account for the fiscal damage caused by ineffective and opaque tax incentive regimes. We also call for stronger regional and global mechanisms to turn the increasing concerns about the prevalence of tax incentives expressed by civil society, experts and multilateral institutions alike, into concrete action.

Tax incentives for cross-border investments

The focus of this paper is specifically on tax incentives used to attract investments across borders with different tax jurisdictions (i.e., the scope of the location or zone where incentives are applied). Such tax incentives have been widely used on the justification that they attract investments. Yet there is mounting evidence that they are largely ineffective. So why are they still so popular among politicians and policymakers?

Rationale for tax incentives

Tax incentives are inducements that aim to attract flows of capital into preferred locations and sectors of the economy or to undertake specific investment activities (e.g., financing infrastructure projects, research and development).⁵ Policymakers justify their use as necessary to drive corporate investments in areas and projects which investors would otherwise not find profitable. Holland and Vann cite the following purposes most often used to justify tax incentives:⁶

- **Regional development** – attract investors to locate to more remote and economically less developed regions of a country.
- **Employment creation** – attract investors to promote the establishment of labour-intensive industries or the employment of particular categories of workers.
- **Technology transfer** – attract investors to bring in advanced technology or research and development activities.
- **Export promotion** – attract export-oriented investment.
- **Free trade or special zones** – export processing zones (EPZ), special economic zones (SEZ), duty-free zones or free trade zones. These provide a discrete environment in which enterprises can import machinery, components and raw materials free of customs duties and other taxes for assembly, processing or manufacturing with a view to exporting the finished product.

Tax incentives reduce a company's tax liability on some taxes, either fully or partially, temporarily or permanently. Tax may be reduced through preferential tax rates, exemptions, special allowable deductions and exclusions from tax base, or outright deduction in the total tax bill (i.e., tax credits). Companies using tax incentives yield a financial gain through higher income or profit and/or lower the cost of investment.

Tax incentives result in foregone revenue for government. They are potential tax revenue that government opts not to collect. Essentially, a tax incentive allocates a portion of the public budget to certain companies, except the money is not collected and does not go through the scrutiny of the budget process.

Tax incentives reduce a company's tax liability on some taxes, either fully or partially, temporarily or permanently. Tax may be reduced through preferential tax rates, exemptions, special allowable deductions and exclusions from tax base, or outright deduction in the total tax bill.

Typical tax incentives

TAX HOLIDAYS

Temporary exemption of a new firm or investment from certain specified taxes, typically at least corporate income tax. Sometimes administrative requirements are also waived, notably the need to file tax returns. Partial tax holidays offer reduced obligations rather than full exemption.

SPECIAL ZONES

Geographically limited areas in which qualified firms can locate and thus benefit from exemption of varying scope of taxes and/or administrative requirements. Zones are often aimed at exporters and located close to a port. In some countries, however, qualifying companies can be declared 'zones', irrespective of their location.

INVESTMENT TAX CREDIT

Deduction of a certain fraction of an investment from the tax liability. Rules differ regarding excess credits (credits in excess of tax liability) and include the possibility that they may be lost, carried forward or refunded.

INVESTMENT ALLOWANCE

Deduction of a certain fraction of an investment from taxable profits (in addition to depreciation). The value of an allowance is the product of the allowance and the tax rate. Unlike a tax credit, its value will thus vary across firms unless there is a single tax rate. Moreover, the value is affected by changes to the tax rate, with a tax cut reducing it.

ACCELERATED DEPRECIATION

Depreciation at a faster schedule than available for the rest of the economy. This can be implemented in many ways, including higher first year depreciation allowances, or increased depreciation rates. Tax payments in nominal terms are unaffected, but their net present value is reduced and the liquidity of firms is improved.

REDUCED TAX RATES

Reduction in a tax rate, typically the corporate income tax rate.

EXEMPTIONS FROM VARIOUS TAXES

Exemption from certain taxes, often those collected at the border such as tariffs, excises and VAT on imported inputs.

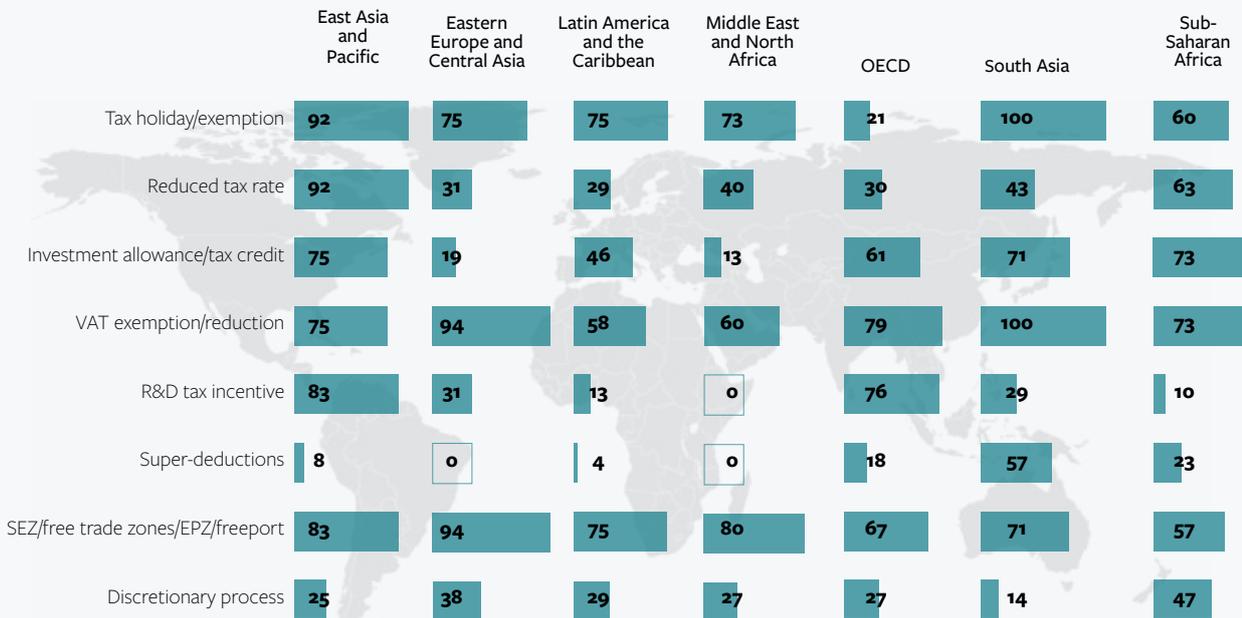
FINANCING INCENTIVES

Reductions in tax rates applying to fund providers, e.g., reduced withholding taxes on dividends.

Source: Klemm, 2009⁷

Tax incentives can take many different forms, such as - tax holiday, reduced tax rates, credit or allowance for investment, preferential accounting standards such as accelerated depreciation, etc.

Figure 1: Prevalence of tax incentives around the world
(percent of surveyed countries using tax incentives per region)



Source: James (2013)⁴

National and international drivers

Decisions to grant tax incentives rest ultimately with sovereign governments. Governments may be motivated by economic reasons – to respond to tax competition, pursue regional and industrial policy, or tackle externalities – or they may be driven by political and rent-seeking motivations.⁸ Thus, institutions and power dynamics within and outside each country come into play in shaping the tax incentive regime. The web of multilateral and bilateral rules and agreements on financial flows across countries, the different tax treatments applicable to these flows, and economic norms and political values underpinning these rules are important external factors to consider in understanding how tax incentives are used and implemented.

Ostensibly, tax incentives are used to compete for investments in the context of ever-increasing mobility of global finance. Their proliferation is a manifestation of international tax competition, i.e. countries competing against each other to win foreign direct investment into their country, using a range of increasingly generous tax breaks as incentives to do so.

As the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) stated: ‘Corporate tax reform in Asia and the Pacific has been both rate-reducing and base-reducing, [supporting] the hypothesis that countries in the region compete with each other in setting their corporate tax rates.’ ESCAP noted a study which warned that ‘the paucity of coordination and har-

Decisions to grant tax incentives rest with sovereign governments. However, multilateral and bilateral agreements, political values and economic norms are important external factors impacting tax incentive regimes.

monisation on tax matters in the ASEAN region... could result in continued tax competition that will have adverse effects on tax bases in the region.⁹

It is crucial to understand that tax incentives regimes in the Global South did not develop overnight. Faced with fiscal deficits in the 80s, these countries turned to the International Monetary Fund (IMF) for assistance. Part of the IMF's loan conditionality were structural adjustments that entailed the implementation of fiscal and non-fiscal incentives to create “favourable” business climates to attract foreign investment. These have had deep and long-lasting impacts on the revenue-raising capacity of Southern countries that continue to be felt today, such as the progressive decline of corporate income taxes (CIT) and the loss of relatively easy-to-collect trade taxes.¹⁰

Financial transparency and good governance

Taxation is the primary source of public revenue. Any exception made from contributing fairly to the public purse and to the public interest should be strongly justified and strongly regulated. In order for tax incentives to be seen as legitimate, they require justifiable reasons for their use, to be properly designed, and to be underpinned by transparency and good governance in order to deliver benefits and incur minimal and acceptable costs. This can be achieved where the foundations for good governance are applied in the formulation, authorisation, implementation and evaluation phases.

Transparency stems from availability and ease of access to data and information and clarity of processes, from inception of tax incentive designs to evaluation of their performance. They allow for public debate on the merits of tax incentives and their cost to government and society at large. Accountability requires policymakers and bureaucrats to publicly justify decisions to grant incentives and for them to be held to account for the consequences. Clarity of rules and their consistent application ensure predictability and limit discretion and concentration of power on important decisions to one or a few individuals. Participation allows more inclusive processes and inputs from within and outside of government in overall administration of tax incentives.

As the IMF has pointed out: ‘Good governance of incentives is critical for their effectiveness and efficiency.’ The IMF underscores that: ‘Transparency is necessary to facilitate accountability and reduce opportunities for rent seeking and corruption.’¹¹

How tax incentives become harmful

Tax incentives can only be seen to work when their use is properly justified or they deliver intended short- and long-term results (i.e., attract the right investments and generate social benefits) or when the associated costs, both expected and unintended, are economically and socially acceptable. In the Global South, redundant tax incentives – those which are unnecessary in attracting investment – abound.

There is no compelling body of evidence that strongly argues for their general effectiveness, and their necessity in the Global South remains highly doubtful. Studies that have shown correlation between tax incentives and investment are true only for OECD countries. And even then, since they are usually offered along with non-tax perks, one cannot completely attribute the cause of investment flows solely to tax incentives.¹² Considering the revenue cost of granting incentives, it remains unclear whether they are beneficial overall for the Global South.¹³

Technical soundness and political integrity in the process of policy making on tax incentives must be put in place to prevent the adoption and continued use of harmful tax incentives. Unjustified use and faulty design make tax incentives prone to abuse and leave government and citizens to bear the costs.

Misused and ineffective tax incentives

Tax incentives fail when they are offered to try and compensate for problems that are perceived to be off-putting to potential investors. Research shows that investors consider many other factors ahead of tax policies, such as economic and political stability, reliable infrastructure, availability of natural resources and human capital. If a location fails to meet their needs in terms of these non-tax factors, they will not even get to the point of examining the availability of tax incentives as part of their decision-making.

Another factor that investors may consider is whether double taxation avoidance (DTA) agreements exist between their resident country and the country where they are considering investing. DTAs allow foreign entities to not pay certain taxes in the host country when they take home their incomes or dividends.

The OECD concluded that there is a consensus on the main factors affecting foreign investment location decisions.¹⁴ The most important ones are market size and real income levels, skill levels in the host economy, the availability of infrastructure and other resources that facilitate efficient specialisation of production, trade policies, and the political and macroeconomic stability of the host country.

A survey of foreign investors in sub-Saharan Africa found that when they were

Tax incentives are justified only when they deliver intended short- and long-term results (i.e., attract the right investments and generate social benefits) and when the associated costs are economically and socially acceptable.

asked to rank business location factors, incentive packages were second last in importance.¹⁵ World Bank and IMF studies in the Global South too echo the finding that tax incentives are not the make-or-break criteria for investors and their effectiveness is ‘linked to the environment where they are offered; in this case the quality of the investment climate is what matters’.¹⁶

Failure to establish basis on economic policy and strategy

When governments grant tax incentives, the foregone revenue is seen as a necessary trade-off for some expected benefit for society. The social benefit of tax incentives is not the financial gains generated by the firms that avail themselves of them, but the impact of the investment activity, such as generating new jobs and broadening the tax base as a result of more economic activities. This underscores the importance of clear links between incentives and broader development strategy.

Table 1: Classification of tax incentives

Tax expenditure (comprising both profit-based and cost-based)

Profit-based tax incentives (tax waivers, tax breaks)				
	No geographical constraint 		Economic zone (EZ) 	
	Temporary	Permanent	Temporary	Permanent
Partial tax reduction	Tax reduction holiday	Tax reduction concession	Tax reduction holiday	Tax reduction concession
Complete tax exemption	Full tax holiday	Tax exemption	EZ full tax holiday	EZ tax exemption

Cost-based tax incentives (tax credits, tax refunds, tax deductions)		
 Capital allowance	 Depreciation rules	 Investment credits

Source: Tax Justice Network ²²

KENYA



Kenyan Incentives for Export Processing Zones (EPZs): Performance and Process Issues

Robert Ssuuna, Tax Justice Network Africa

Export processing zones (EPZs) are designated areas where firms are allowed to import plant, machinery, equipment and material for the manufacture of export goods under security, without payment of duty on imported goods. They were established in Kenya in 1990 with the aim of attracting and facilitating export-oriented investments. The Export Processing Zone Actⁱ offers tax incentives to firms operating in EPZs as a way of providing an attractive and enabling environment for businesses to make investments. The zones are managed by Kenya's Export Processing Zones Authority.

Performance of EPZs from 2012-16 raises concern on the significance and productivity of the incentives granted to the sector. They were expected to catalyze investment and the export contribution of the EPZs to the total exports over the period 2012 and 2016 increased marginally, while the contribution of EPZ exports to GDP remained practically constant over the same period.

The trend reinforces the notion that tax incentives do not necessarily play a huge role in facilitating investment.

Many commentators contend tax incentives may now play a larger role in influencing investment decisions than in past yearsⁱⁱ but no clear evidence can support this due to the lack of a review mechanism to assess their relevance and progress towards achieving the intended objectives. What is more widely known though is that while tax incentives can make investing in a particular country more attractive, they cannot compensate for deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructureⁱⁱⁱ.

Government can provide better alternatives to improve the investment climate as opposed to blanket tax holidays, such options include reduced power costs, improved infrastructure, transparent governance of the tax incentives regime and improved security among others.

Attempts were made to remedy the dangers of revenue losses resulting from EPZs through the 2018 Income Tax Bill^{iv}. It sought to ring-fence the benefits of incentives so EPZs that do not engage in commercial activities are subject to increasing tax rates ranging from 10-30%. However, the amendment solves only part of the problem for two reasons. First, it only applies to enterprises in newly

i. Cap 517 of Kenyan Laws

ii. Alex Easson, Tax Incentives for Foreign Investment, Part I, Recent Trends and Counter-trends, 55 Bulletin for International Fiscal Documentation 266 (2001).

iii. Eric M.Zolt, Tax Incentives and Tax Base Protection Issues, Draft Paper No. 3, Papers on Selected Topics in Protecting the Tax Base of Developing Countries

iv. Paragraph 3(d-e) of Part A of the Third Schedule of the Income Tax Act 2018 as amended.

Tax incentives that are accessible to firms operating in the EPZs in Kenya

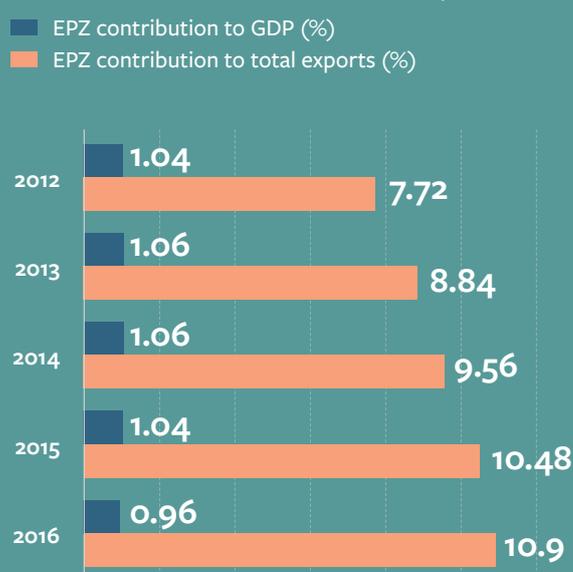
Standard Tax Rates for Non EPZ enterprises	Export Processing Zone (Preferential rates).
Income Tax - Corporation Income Tax at 30%	10% for the first ten years from date of first operation and thereafter 15% for another ten years, after which 30% applies ^v .
Withholding Tax – Range 5% to 20%	Dividends and other payments to non-residents during the 10-year tax holiday. Subsequently, withholding tax for non-residents will be: Interest - 15%, Dividends - 10% Management and Professional Fees - 20% Royalties - 20%.
Investment Deductions	100% of the capital expenditure on building and machinery applicable for over a period of 20 years.
Value Added Tax (VAT) – standard rate of 16%	Perpetual exemption from VAT and customs import duty on inputs – raw materials, machinery, office equipment, certain petroleum fuel for boilers and generators, building materials, other supplies.
Stamp Duty	Perpetual exemption from payment of stamp duty on legal instruments.

created EPZs. Secondly, it defines commercial activity in its broadest form and such a broad definition provides room for abuse.

There are glaring loopholes in the legal regime that govern gazettement of such zones and granting of exemptions. Section 29 of the EPZ Act provides the benefits to any firm that is licensed to operate within the zone. However, Section 29(2) (i) gives the Cabinet Secretary, “Finance powers to grant any other exemptions in addition to the ones that have been clearly stipulated.” This creates room for the Cabinet Secretary to arbitrarily choose who benefits from incentives. This discretionary power creates opportunities to abuse the incentives regime through lobbying and rent seeking.

Kenya’s EPZs tax incentives regime remains susceptible to abuse through exploitation of loopholes in the legal framework. Changes in the Income Tax Act, if not matched with amendments in the EPZs, will not solve the tax base erosions risks associated with discretionary tax incentives.

Performance of EPZs (2012–16)



Source: EPZ Annual Performance Report 2016

v. Prior to 1st July 2018, The preferential rate was 0% for the first ten years and 25% on profits thereafter.

Tax incentives must be used in pursuit of an industrial policy that is part of a strategic development plan. The policy and plan should be the basis for designing tax incentives that will only apply to the type of investments needed in a specific industry or location.

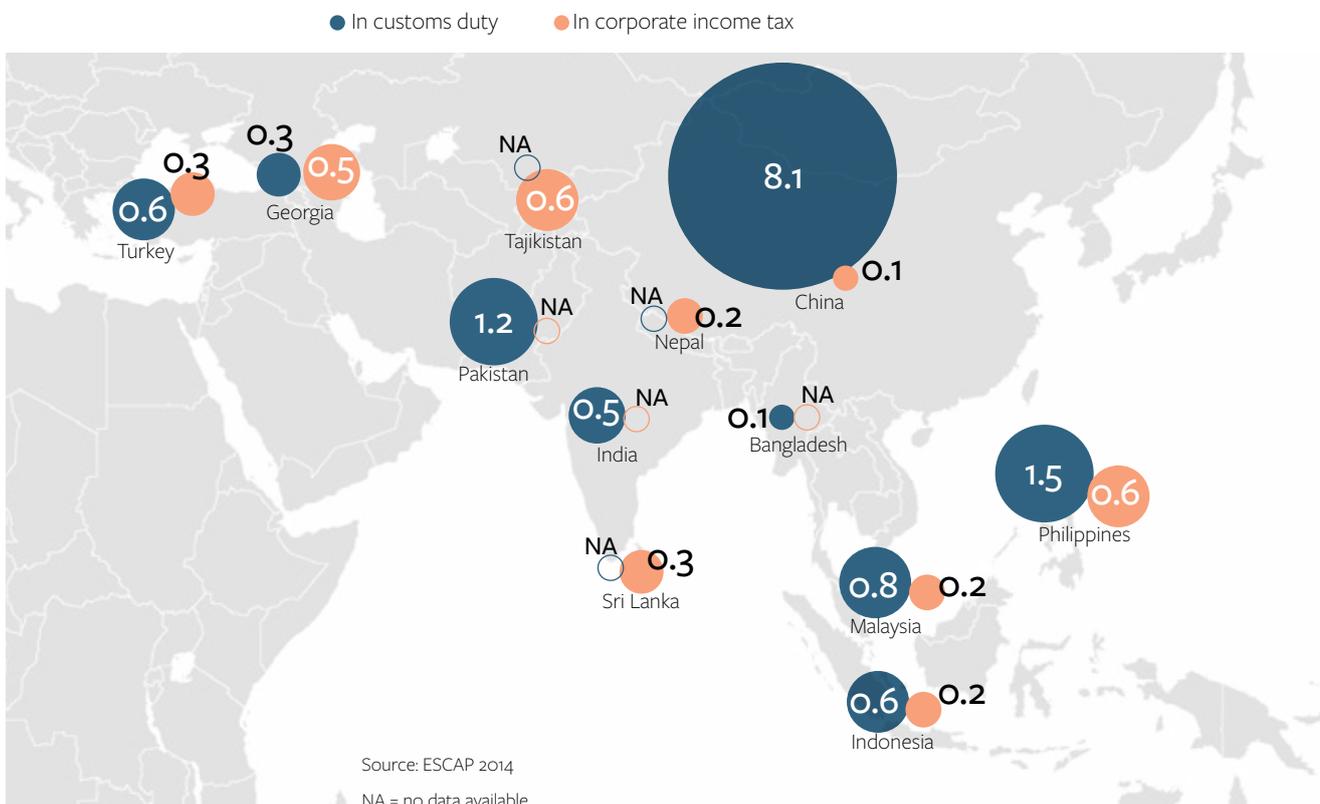
When tax incentives are given for reasons of economic self-interest ('rent-seeking') and result from private lobbying and/or discretionary decision-making, they work for the financial gain of the company involved and those with whom they have colluded and have no or limited social benefit. The absence of credible technical justification for an incentive's link to economic strategy or broader social benefit, no clear rules limiting the scope and eligibility, and overall lack of transparency in the process all lead to misuse of tax incentives. Under these circumstances, the policymaking process tends to be more vulnerable to corruption with potential consequences to the economy, democracy and development process.¹⁷

Poor targeting of tax incentives

Not all investments respond to tax incentives the same way. Efficiency-seeking ventures, such as export-oriented firms, are sensitive to tax incentives because of its cost-reducing effect.¹⁸ Mobile capital benefits from tax incentives but this investment too is not as useful for long-term development.

Resource-seeking (e.g., extractives) and market-seeking investments are known not to be sensitive to tax incentives, since the physical attributes of the location (e.g., availability of natural resources, size of market and vicinity) are

Figure 2: Tax expenditure as a percentage of GDP in selected countries





BRAZIL

Perverse tax incentives: a major obstacle for sustainable development in the Amazon

Marcos Lopes Filho, Christian Aid

Research from the Brazilian Institute of Planning and Taxation (IBPT) shows that 79% of the population of Brazil receives no more than three times the minimum wage, and yet this group contributes 53% of all tax payments.

According to the Institute for Social and Economic Studies (INESC) in Brazil, tax incentives have been responsible for a double burden on the peoples of the Amazon (especially indigenous and Quilombola communities) for over 50 years. On one hand, tax incentives have attracted extractive companies to the region that have brought with them violence and degradation of the environment and of the livelihoods of local communities and on the other, tax incentives have also substantially reduced state capacity to promote basic services, especially for those who have been left behind.

Data from the Brazilian National Fiscal Authorityⁱ shows in 2018 alone, a number of extractive companies, with significant interests in the Amazon region, benefited from nearly US \$1 billion worth of tax incentives. In the next 5 years, these companies will receive additional tax incentives worth in the region of US \$9 billion to extract and export the public goods of the rainforest. To put these numbers into context, over the same period the Brazilian Governmentⁱⁱ is planning to invest the same amount of money (US \$9 billion) into education, social protection, and food and nutritional security.

Taking the state of Pará as an example, an INESC study re-

veals that, between 2007 and 2013, it should have collected \$US 3 billion of state value-added tax from the mineral sector. As a result of the offered tax incentives, the state received just \$US 600 million in royalty payments. This meant an effective loss of 78.8% of the collection capacity. This situation is made more serious because Pará is very dependent on the mineral sector, with mining representing 68.3% of the state's trade balance.

The "choices" of the federal government and the state of Pará to grant so many tax giants privileges to mining bring a direct reduction in the federal and state fiscal capacity to invest in public policies - such as health, education, environment, sanitation. This in turn reinforces the existing picture of serious regional inequalities and social exclusion.

Additionally, the low appropriation of mineral income through taxationⁱⁱⁱ, together with the low labour cost, help explain why Brazil has the lowest production costs (mine cost) on the planet^{iv}. Lower costs, coupled with the quantity and quality attributes of Brazilian and Amazonian mineral reserves, help explain the recent boom in mining growth in Brazil and the Amazon, driven by Chinese demand and supported by these advantageous (for the companies involved) conditions. So the fiscal and economic crises that Brazil is experiencing are linked together in a vicious cycle fueled by inequality: fiscal adjustment, rising interest rates and reduced employment have penalized the poor who are consuming the least, leading to a reduction in tax revenues, drastically decreasing and widening the fiscal and economic crisis.

i. See here: <http://amazonia.inesc.org.br/materias/isencoes-fiscais-para-empresas-na-amazonia-mais-de-50-anos-sem-transparencia-e-efetividade/>

ii. INESC, CESR and Oxfam Brasil (2018). Monitoramento Dos Direitos Humanos Em Tempos De Austeridade No Brasil. Available at: https://www.inesc.org.br/wp-content/uploads/2018/08/Rel_Dir_Hum_Temp_Aust-NOVO-1--V3.pdf?x40748

iii. Available technical studies point Brazil to one of the countries that least appropriates mineral income through taxation. For a synthesis of these studies see BRASILE.U.R & POSTALI.F. The Brazilian Mineral Code and Compensation for the Exploitation of Mineral Resources - CFEM. 2014. Available at http://downloads.fipe.org.br/publicacoes/bif/2014/7_bif406.pdf

iv. BNDES report on Iron ore shows that in 2012, the world average mine production cost was 80.03 cents per dry metric ton (c / dmtu). In Brazil this cost was only 41.10 c / dmtu, 20% below the second lowest cost in Australia, which was 51.72 c / dmtu.

of primary consideration. In the case of the extractives industry, no amount of tax breaks can lure a company where natural resources are scarce or non-existent. In fact, some argue that natural resource-based investments should be taxed ‘to ensure that locational rents are shared with the host country in a sustainable way’.¹⁹ Bantay Kita, a non-governmental organisation in the Philippines, considers tax incentives at the point of resource extraction as unnecessary.²⁰

Using inefficient incentives design

Tax incentives can be broadly classified as profit-based and cost-based. Profit-based incentives minimise taxes on income, while cost-based incentives reduce the cost of capital. Generally, cost-based incentives are considered better because they are more efficient and the cost to government revenue of the incentives is linked to an increase in capital investment made. Profit-based incentives may be in the form of lower tax rates or tax exemptions, partially or fully, for a specified period of time (i.e., tax holiday). They are generally discouraged because they attract short-term investment that can easily be withdrawn once the holiday period is over or reinvested under a new company with the same owners, effectively extending the incentives. Short-term investments are not expected to generate longer-term social benefits.

Countries from the Global North have been observed to use more efficient cost-based incentives, while those from the Global South tend to offer more of the less-efficient tax holidays and exemptions.²¹ When profit-based incentives are granted in a manner without clear criteria for determining which companies may use the incentives, discretionary power is concentrated on a select group of officials or agencies, which creates opportunities for corruption and private lobbying. Incentives awarded through the discretionary process create efficiency losses that hurt government coffers.

The cost of tax incentives

Whenever tax incentives are granted, the government and, ultimately, its citizens bear the costs in various ways. The most obvious cost is foregone revenue for the government, which limits its financial capacity to deliver more public services. Displacement and administrative costs are also incurred when offering tax incentives.

Foregone government revenue

While the prevalence and forms of tax incentives used are well documented, there is no definitive data on the global magnitude of incentives because not all countries collect and publicly report such data. Even if they do, there is no common methodology for reporting across all countries.

In 2013, Action Aid estimated that \$138bn of CIT was waived by developing countries every year.²⁷ For Latin American countries, Pecho estimates that on average, CIT and VAT incentives granted were 0.89% and 2.05% of GDP, respectively.²⁸

ESCAP estimates that in 2014 select Asian countries granted tax breaks ranging from 0% to 0.6% and 0.1% to 8.1% of GDP from CIT breaks and customs duties, respectively.³⁰

Whenever tax incentives are granted, the government loses the potential tax revenue that could have been instead used to deliver the essential public services.

PHILIPPINES

Overly generous, inequitable, ineffective, and wasteful

In 2015, the government estimated its foregone revenue due to tax incentives was PHP301bn (\$6.6bn). In the same year, the deficit reached PHP121.7bn (\$2.67bn). The incentives could have easily covered the annual national budget for health (PHP104.96bn/\$2.31bn) or social security and welfare (PHP231.34bn/\$5.09bn). Had the regular tax rates been imposed and the incentives been collected, tax effort for the year would have improved to 15.9% instead from the actual 13.6%.²³

These forgone revenues arise from a complex incentives system, whereby 14 investment promotion agencies (IPAs) are authorised to grant tax incentives under 136 investment and 200 non-investment laws. Some of the IPAs operate 546 'ecozones' and freeports where tax holidays and other forms of special tax treatments are granted to select investors.

Tax incentives are biased towards large companies – 2,844 firms were granted incentives and paid a tax rate of between 6% and 13%, while almost all small and medium enterprises (90,000 businesses) pay the regular 30% rate.²⁴ Some 645 firms have been receiving incentives for at least 15 years.²⁵

A Department of Finance cost-benefit analysis of fiscal incentives in 2018 revealed findings that underscore the ineffectiveness of tax incentives system:²⁶

- Despite the Philippines giving the most generous incentives, foreign direct investments pales in comparison to its neighbours, export competitiveness has been declining, domestic industries have weak linkages to export industry, and reliance on imported parts (thus weak domestic content).
- In 2015, 123,725 jobs were created from PHP301bn

(\$6.6bn) in tax incentives. This means that it cost taxpayers around PHP2.4m (\$57,700) to create one job.

- Comparing IPA-registered firms with non-registered companies shows that IPA-registered businesses have the same employment levels relative to size and similar average wages. They spend more on fixed assets (as expected), but not on research and development. IPA-registered firms have the same level of exports relative to sales, and there is no difference in productivity.
- On average, for every peso granted as incentive, 34 cents in taxes were collected, even after accounting for taxes from indirect employment and domestic inputs.
- On average, for every peso spent on incentives, between PHP0.63 and PHP1.21 comes back in benefits, even after accounting for employment generated and spillovers, both direct and indirect.
- More than half (56.9%) of the incentives granted to 2,844 firms in 2015 are considered purely unnecessary, since their investments would have occurred even without offering tax incentives.

The study concludes that incentives must be performance-based, targeted, transparent, time-bound; with effective monitoring and evaluation system; and, anchored on a strategic investment priority plan that emphasises: job creation, research and development, countryside development, skills training and innovation.

The medium-term solution is to address infrastructure gaps, corruption, inefficiency in government and complex business regulations.

Table 2: Tax expenditures and incentives by tax, as percentage of GDP, 2012

	Income tax				
	VAT	CIT	PIT	Total	Others
Argentina	1.19	0.08	0.52	0.61	0.61
Brazil	1.12	0.86	0.73	1.59	0.60
Chile	0.88	0.86	2.73	3.58	-
Colombia (2010)	1.68	1.24	0.32	1.56	-
Costa Rica	3.54	0.80	1.02	1.82	0.26
Ecuador	2.09	2.31	0.46	2.77	-
El Salvador (2010)	1.97	NA	NA	1.42	-
Guatemala	1.96	NA	NA	5.90	0.54
Honduras	3.63	1.08	0.27	1.35	1.48
Mexico	1.51	0.92	0.83	1.75	0.56
Panama	2.27	-	-	-	-
Paraguay (2010)	1.48	0.23	0.20	0.43	-
Peru	1.30	0.21	0.15	0.37	0.24
Dominican Republic	3.23	0.42	0.10	0.52	1.37
Uruguay	2.95	1.66	0.63	2.29	1.16
Simple average	2.05	0.89	0.66	1.85	0.78

Source: Pecho.²⁹ NA = no data available.

Many researchers and institutions have attempted to estimate the magnitude of incentives, but they are not comparable with each other. There is no generally agreed method of computation, no agreement on what should count as tax incentives, and no common reporting format used across countries. At the very least, what these estimates reveal is that the amount of potential tax revenue that the Global South willingly gives away to attract investments is not insignificant. Are these incentives better off in the hands of private investors instead of being collected by government and spent on public services?

Some argue that foregone revenue should only be counted where incentives have been given to investments that would have been undertaken in any case or where incentives have been improperly claimed.³² The first arises from using redundant, ineffective and misused incentives, as described in the previous section. The second scenario results from abusing tax incentives. This is done when two or more related firms (e.g., those which have the same owner or are subsidiaries of a common corporation) shift income from one firm that is not qualified for incentives to another one that can claim the tax break. However, unless there is a clear and public accounting for the benefits of any incentives offered, it seems reasonable to include the known foregone revenue as part of any cost calculation of providing incentives

Resource allocation costs

Tax incentives have a distortionary effect ‘which tend to discriminate against smaller firms, against local firms (de facto, though rarely on a de jure basis) and against firms in sectors or types of activity that are not targeted – and such effects can be significant.’³³

Incentives discriminate against local businesses and put them at a financial disadvantage. The uneven playing field is worsened with the presence of transnational companies, which may have the ability to use offshore tax vehicles to shift profits. In this case, not only are local smaller firms disadvantaged, but the integrity of the tax system is also undermined.³⁴

Displacement costs must be considered in evaluating the desirability of tax incentives. Existing firms that had to close business and lay off employees must be weighed against setting up of new firms and new jobs that have been generated by the investment. An empirical study covering more than 40 developing countries did not observe any effect of tax rates and tax holidays on FDI on total investment or economic growth. The authors surmised that this may be due to a crowding out effect (i.e., new firms only replaced old local investments) or that ‘new’ investments were only transfers of ownership rather than new investment.³⁵

Enforcement and compliance costs

Since tax incentives are special treatments or exemptions from how general tax rules are applied, their implementation requires additional tasks from tax authorities. These tasks require administrative resources to be spent on tax inspection, processing returns, case-by-case monitoring and evaluations, etc. In some countries, the functions of reviewing qualifications, deciding which firms will be allowed to claim, determining the kind of and rates of incentives to be granted, and monitoring and reporting are not centralised into one agency. Some forms of abuse of incentives, such as profit shifting, involve more than one firm and can span more than one tax jurisdiction or country. Coordination with more agencies will therefore be necessary to ensure that abuses do not happen.

Gaps in the system of periodic collection and public reporting of tax incentives are important issues to address, along with the low capacity of tax administrators to manage and access information for tax monitoring purposes. These are barriers to conducting more rigorous analysis for the purpose of improving policy and administration of tax incentives.

Costs associated with corruption and lack of transparency

Whenever the question of whether or not to set a law allowing tax incentives is on the agenda, the political decision-making process (e.g. parliament) opens space for lobbyists to influence policymaking in favour of offering tax incentives. In cases where there are pre-existing tax incentives, the clamour may be to extend them despite having served their purpose, or to make them even more generous. There is an inherent interest for existing and prospective investors to do so, regardless of whether they need them or not.

Incentives discriminate against small businesses, and put them at a disadvantage while competing against big businesses and TNCs. Bigger players have access to sophisticated channels to help them exploit tax incentives.

INDONESIA

Dirty money from dirty coal

Mae Buenaventura,

Asian Peoples' Movement on Debt and Development

The Jakarta-based firm Adaro Energy (AE) has swiftly grown into one of the largest producers of thermal coal in Indonesia and South-East Asia. By 2017, it posted net profits of more than \$480 million, surpassing Indonesia's largest coal producer.ⁱ The following year, AE's revenues leaped to \$3.6 billion.ⁱⁱ AE now has offshore presence in well known tax havens: Coaltrade Services International Pte. Ltd. (Singapore); Arindo Holdings Ltd. and Vindoor Investments Ltd. (Mauritius), and more recently, Adaro Capital (Labuan, Malaysia).ⁱⁱⁱ

PT Adaro Indonesia (AI), AE's biggest mining company, operates Indonesia's single largest coalmine under a 30-year Coal Contract of Agreement (CCA). Awarded in 1982, the CCA targeted investors for Indonesia's still fledgling coal industry. One of the incentives was granting CCAs with special legal status that protected early investors against any change in Indonesian tax and investment laws.

The CCA program underwent changes in later years to favor fully owned domestic players, but the first CCA holders such as Adaro maintained a greater advantage.^{iv} Fiscal stability clauses ensured fixed corporate tax rates and exemptions throughout the contract period unlike later CCAs that were more open to amendments.^v

At one point, the Finance Ministry set new rules that coal producers would no longer be allowed to offset input VAT from output VAT; and removed the VAT exemption on materials and equipment. When questioned for

offsetting claims for recoverable VAT against royalty payments, the company cited CCA terms that, "the Government will pay, assume and hold AI harmless from all Indonesian taxes, duties, rentals and royalties levied by the Government imposed after the date of the CCA." The Supreme Court eventually ruled in 2017 that while AI had to settle the unpaid royalties, it will be refunded for VAT payments made after coal production became VAT-exempt in 2000.^{vi}

Warning signs of profit-shifting through tax avoidance schemes is clearly illustrated by AIs' dealings with its Singapore-based holding firm.^{vii} Indonesian revenue officials found out that it had bought coal from AI at \$32/tonne and subsequently sold it to third parties when prices rose to \$39/tonne. Profits were then booked in Singapore and taxed at only 10.7% (as compared to Indonesia's 50.8%). The company later agreed to settle by paying \$33.2 million to the government.^{viii}

For almost a decade, Coaltrade sourced more than 70% of the coal it was selling, from Adaro subsidiaries in Indonesia. Global Witness estimated that from 2009-2017, Indonesia had forgone corporate taxes of \$125 million or \$14 million/year. Meanwhile, Coaltrade enjoyed a spike in commissions from an annual average of \$4 million to almost \$55 million during the period.^{ix}

Adaro Indonesia holds a "Golden Taxpayer Status" award, which comes only as the latest of many accolades for being a model taxpayer.^x Have the shadowy shifts in profit to tax havens and the massive revenues forgone been lost as well in the tax-privileged world of the Indonesian coal sector?

i. Tani, Shotaro. "In ironic twist, drive for clean energy creates Asian coal boom." *Nikkei Asian Review*, 9 July 2018). <<https://asia.nikkei.com/Business/Markets/Commodities/In-ironic-twist-drive-for-clean-energy-creates-Asian-coal-boom>>.
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v. Lucarelli, p. 29

vi. 2017 Adaro Indonesia Annual Report, p. 324-325.

vii. Indeed, the report of Global Witness on Adaro's alleged transfer pricing abuse, using its Singapore-based financial hub Coaltrade Services International, bears this out.

viii. Global Witness. "Indonesia's Shifting Coal Money, How vast sums have been moved offshore and out of sight, Part 3: Taking Times for Adaro." July 2019. P. 4-5.

ix. Global Witness. "Indonesia's Shifting Coal Money..."

x. Criteria include not having any criminal conviction in the last five years.

The Tax Justice Network, a UK based non- governmental organisation, noted that governments are under pressure, particularly from business consulting firms, to offer tax incentives to compete for investments, while transnational corporations exert their political influence to gain more favourable tax treatment.³⁶

The confluence of these factors and the absence of tax agreements across regimes opens up space for corrupt practices. Additionally, the Tax Justice Network cites the case of Halliburton in Nigeria, which stands accused of bribing tax officials for incentives, as an example.

In cases where the legal system already allows tax incentives, the degree of specificity or ambiguity of rules determines the size of the space for unscrupulous firms to corrupt the implementation. Since tax incentives provide exceptions from general rules and norms of taxation, there should be clear rules on what should qualify for incentives, along with transparency in the process of selecting who receives tax breaks and by how much. Ambiguity will make implementation highly discretionary and prone to personal back-door lobbying.

Hearson points out that it is ‘widely agreed that discretionary tax incentives, which are often negotiated in secret by politicians or officials, are most undesirable because they are economically inefficient, pose a corruption risk, and are the result of agreements made outside the process of democratic scrutiny that is important for the fiscal policymaking process.’³⁷

Corruption in policymaking and implementation distorts the relationship between state and citizens and undermines democratic and public administrative institutions.

Governments are put under pressure from business consulting firms and transnational corporations to offer tax treatments which are more favourable than the existing ones and also more lucrative than the ones in neighboring countries.

Illicit features of harmful tax incentives

Harmful tax incentives exhibit the same illicit features as most other IFFs and are enabled by financial opacity and weak governance mechanisms. They flourish in a global financial system that irrationally privileges private investments over public finance. The definition of IFFs is an ongoing debate. Chowla and Falcao frame IFF as a subset of the broader concept of illicit finance and highlights the ‘grey area’ representing the debate on what should count as illicit.³⁸ This paper does not seek to settle the debate, but rather looks at the different lenses of illicitness to show how they are manifested in harmful tax incentives.

Illicit as illegal

Illicit as illegal is where it contravenes the intent of law and principles behind policy. Herkenrath points out that: ‘equating illegal and illicit financial flows implies the existence of a legal system that reflects an overall societal consensus and which is sufficiently developed to represent central social and economic interests. In the case of some developing countries, this assumption applies only partially or not at all.’³⁹

Public policies set out a government’s goals and strategies, which are shaped by technical analyses and principles. Laws are instruments for advancing policies and must be viewed in conjunction with the principles behind the policies for which they serve.

The conventional view of illicit are those that are illegal, i.e., not in accordance with the letter and intent of the law. When laws on tax incentives exist and provide clear rules on eligibility, tax treatment, authority to grant and process for enforcement and implementation, tax incentives granted in a manner inconsistent with these rules must be considered illicit. It may also include incentives granted when no legal basis exists, including those granted by sub-national governments (e.g., states in a country with a federal system) without legal authority to do so.

Tax incentives offered without any basis in socio-economic policy or strategy, with no benefit of evidence-based justification or that are generally ineffective in attracting investment may be considered illicit.

Laws that are poorly formulated with unclear rules on enforcement create opportunities for abuse. For example, legal gaps that do not explicitly prevent practices like intra-firm profit shifting for tax avoidance purposes may be exploited. Where individual government officials are given latitude for discretion, this can be exploited through influence peddling, bribery and other such practices. Where these practices are successful, incentives granted may be considered illicit.

Tax incentives that grossly undermine tax and other fiscal policy principles

When laws on tax incentives exist and provide clear rules on eligibility, tax treatment, authority to grant and process for enforcement and implementation, tax incentives granted in a manner inconsistent with these rules must be considered illicit.

(e.g., efficiency, equity and administrative simplicity) may also exhibit an illicit nature.

Firms may operate without licenses or without complying with social and environmental standards, and still enjoy tax incentives. Proceeds from these kinds of business activity count as illicit finance as well, having been generated by illegal activity.

Illicit as negative impact to the economy

An alternative concept of illicit finance is a flow that has a ‘negative impact on an economy if all direct and indirect effects in the context of the specific political economy of the society are taken into account.’⁴⁰

Building a case to argue that a tax incentive is illicit finance can draw from existing evidence showing that the practice of granting tax incentives in developing countries can undermine the state’s capacity to deliver development outcomes. Revenue costs generated by redundant or unnecessary incentives could have contributed to public budget for social services, infrastructure and other development needs. Distortionary effect caused by tax incentives may also fall under this.

Illicit as violation of rights

The Kathmandu Declaration on IFFs offers another perspective of illicit, highlighting that IFFs run counter to the full realisation of human rights.⁴¹ Incentives that create conditions that undermine the full realisation of rights through an impact on public finance; threaten rights when offered in conjunction with promotional package that includes relaxing of labour standards in SEZs, encroaching on land rights and gender-based discrimination. They also include generally opaque and secretive processes governing tax incentives that run counter to the right to information and participation.

The debate on defining IFFs is underpinned by the quality and integrity of governance that shapes the standard for what is socially acceptable – legally, ethically, and morally. Illicit finance is enabled by poor governance – opacity and secrecy, unclear rules, discretion, and concentration of power to few individuals with no accountability for decisions and their consequences.

Tax incentives are often part of investment package offered to firms looking to set up business in SEZs and EPZs. The investment packages in these zones are controversial because they include non-tax inducements that are inimical to the rights of local citizens. Examples are relaxation of existing labour laws and standards (e.g., banning workers’ right to strike or to organise unions) and conflict over land rights (e.g., land grabs and conversion resulting to forced migration of local communities or indigenous peoples) – both of which disproportionately affect women. These rights issues are not the direct result of tax incentives. They are offshoots of a development paradigm that prioritises business interests over citizens’ needs and allows tax breaks to flourish.

Incentives create conditions that undermine the full realisation of rights through an impact on public finance and threaten rights, especially when offered in conjunction with relaxation of labour standards, encroaching on land rights and gender-based discrimination.

Curbing harmful tax incentives

Harmful tax incentives flourish due to national and global rules on financial flows, characterised by poor governance and overly privileging private sector investments. The developmental consequences of harmful tax incentives and IFFs are essentially the same. It is imperative to instil stronger financial transparency to curb the rampant abuse of tax systems that undermines democracy and handicaps governments' capacity to adequately tackle inequalities and fully realise human rights for all.

Good governance and financial transparency

At the national level, we believe that the following governance mechanisms are essential to effectively detect, deter and stop harmful tax incentives:

- Tax incentive regimes must be underpinned by clear, transparent and credible legal, technical and political processes to deter rent-seeking behaviours that grant tax breaks purely for private gains.
- Tax incentives must be justified by their clear link to national development strategy and positive contribution to specific economic and social policy outcomes. The justification must be backed by technically sound, evidence-based and comprehensive assessment by competent authorities. Assessments must evaluate alternative policy options to determine whether tax incentives are the most efficient and effective means to achieve the same policy outcomes. The evaluation should include impact of unfair competition on domestic firms and ensure that growth of local economic activity is not compromised.
- Social costs and benefits of new and existing tax incentives must be evaluated comprehensively to cover externalities, intended and unintended consequences, and consistency with social and environmental policies, labour standards and environmental regulations.
- Laws should specify the scope and limitations of tax incentives. There must be rules setting clear criteria for determining which investments and firms are qualified to avail of tax incentives. Tax incentives are targeted and selective by nature. Ambiguous targeting criteria leave room for discretion, which raises the risk of giving tax breaks to unqualified but well-connected investors. Sunset clauses must also be placed to prevent continued granting of tax incentives that are no longer needed.
- There should be complete transparency on tax expenditures due to tax incentives. Foregone revenue must be publicly reported at all levels of governance and form part of public expenditure review by parliaments and legislative assemblies, and by finance and budget authorities/ministries.

Tax incentive regimes must be underpinned by clear, transparent and credible legal, technical and political processes to deter rent-seeking behaviours that grant tax breaks purely for private gains.

Tax expenditures must be analysed to determine if they are consistent with budget policies. They must also be subject to review by state audit authorities, as with direct public spending.

- Tax incentives must be subjected to ongoing review and monitoring by government. Technical evaluations must be subjected to parliamentary oversight and publicly reported. Reviews must lead to decisions to terminate those that are determined to be harmful tax incentives or no longer serve their purpose. Mechanisms for people’s participation in monitoring social impacts must be put in place.
- Freedom of information laws must extend to firms using tax incentives. Financial information used as basis for computing and claiming tax breaks must be reported and publicly available for scrutiny. Tax incentives must be treated the same way as public expenditure by the government. Tax administrators and state audit authorities must have access to the financial information that is necessary to validate the basis for the tax breaks being claimed. Bank or financial secrecy laws that may prevent authorities’ access to this information must be amended.

International cooperation

Global and regional intergovernmental bodies must coordinate and pursue common policy measures to stop tax competition. Strengthening transparency in cross-border financial flows, such as country-by-country reporting, beneficial ownership, automatic exchange of information, international institutional architecture and open data, will support countries to detect, deter and stop harmful tax incentives.

Extraterritorial impacts of tax incentives and spillover analysis should be undertaken systematically by governments as part of their commitments to policy coherence in international solidarity commitments on tax governance. This issue is especially pertinent in tax havens and in the Global North, where tax incentives can have an adverse extraterritorial impact on countries in the Global South.

Mechanisms and policies must be negotiated to harmonise investment promotion within regions without individual countries losing out on unnecessary losses from tax incentives. The Independent Commission for the Reform of International Corporate Taxation has set aside a few recommendations to stem tax competition:⁴²

- Put a floor under tax competition. Agree on a global minimum effective tax rate and work towards a common definition of the tax base.
- Eliminate all tax breaks on profit. Grant tax breaks sparingly and only on local costs to support new productive investment.
- Establish a level playing field. End special tax treatment for foreign and/or large companies and publish existing agreements.
- Ensure participation. Enable citizen engagement in tax debates and provide civil society access, information and training to productively engage in those debates.

Extraterritorial impacts of tax incentives and spillover analysis should be undertaken to further meaningful international tax cooperation to curb abusive tax incentives and competition.

IRELAND & UK

Commodifying sovereignty: Cases from Ireland and the United Kingdom

Tove Maria Ryding, European Network on Debt and Development and Toby Quantrill, Christian Aid

Tax incentives are not just a problem for countries in the Global South. They are a pervasive feature of tax regimes across the globe and can have an impact far beyond the ‘sovereign’ borders of the countries involved. For example, in June 2019, the European Commission highlighted Ireland as one out of six EU Member States that have features in the tax systems which “*may be used by companies that engage in aggressive tax planning.*”ⁱ Such tax structures are a type of tax incentives that can have significant negative impacts far beyond the country where they exist. Because multinational corporations can shift their profits from the countries where they conduct their actual business activity to countries where they enjoy low tax rates, the incentives can also undermine the tax income of other countries around the world. The detailed reality of these impacts were explored in a report by Christian Aid Irelandⁱⁱ, which laid bare the specific elements of Irish tax corporation tax policy that have an impact on developing countries.

In 2016, the European Commission ended a state aid investigation into Ireland’s tax treatment of the tech giant Apple with the conclusion that “*Ireland granted undue tax benefits of up to €13 billion to Apple. This is illegal under EU state aid rules, because it allowed Apple to pay substantially less tax than other businesses.*”ⁱⁱⁱ The Commission’s calculations suggested that Apple’s effective tax rate in Ireland was as low as 0.005%.⁴ The Commission’s state aid decision was appealed to the European Court of Justice, where the case is still ongoing. While this case concerns the Irish tax system from 2003-2014, and the

system has evolved since then, a story from the International Consortium of Investigative Journalists (ICIJ) in 2017 suggested that Apple’s tax planning had changed, to fit the new Irish tax system and that Apple was continuing to use Irish structures to lower the corporation’s tax payments substantially.^v

A specific example of a type of tax incentive widely used in developed countries is the so-called ‘Patent Box’, which enables companies to apply a lower rate of Corporation Tax to profits earned from their patented inventions and equivalent forms of intellectual property. The UK introduced such an incentive on 1st April 2013. Under this scheme, the lower rate of Corporation Tax is 10% for the specified earnings, compared with the main rate of Corporation Tax (23% in 2013, falling to 19% by 2019). The scheme is undoubtedly costly. In 2015-16, 1,160 companies claimed relief under the Patent Box with a total value of £754.3 million (US \$975 million) while in 2016-17, 1,025 companies claimed £942.5 million (US \$1.2 billion) relief using the Patent Box.^{vi}

The stated aim of the Patent Box is to provide additional incentive for companies to increase the level of patenting of IP developed in the UK and to ensure that new and existing patents are further developed and commercialised in the UK. The theory is that this will encourage companies to locate the high-value jobs associated with the development, manufacture and exploitation of patents in the UK. In reality however, while the costs of this scheme are evident, the benefits remain far from clear, with strong critiques^{vii} suggesting that few real jobs have been created, while the main effect has been a simple giveaway to globally mobile businesses.

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Endnotes

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The Financial Transparency Coalition (FTC) is a global civil society coalition comprised of the pioneering organizations in the area of illicit financial flows (IFFs). Since its founding in 2009, the FTC has been the forum through which these leading experts on IFFs have collaborated and coordinated efforts around the world to successfully introduce the concept of IFFs to the world, educate governments, the public and private interests about how IFFs undermine global development efforts, and drive the adoption of international measures to break the IFF cycle.