How tax breaks undermine the SDGs

Tax incentives are largely redundant, inefficient and unnecessarily erode public financing for development in the Global South

By Neeti Biyani | 16.01.2020

Who actually benefits from tax incentives?

Faced with multiple and intersecting challenges — development, climate deterioration, human rights abuses and deepening inequality — multiple intergovernmental negotiations and agreements have squarely focused on the question of financing. While the centrality of public financing for development was underscored during the inception of the Sustainable Development Goals (SDGs), there has since been an increased emphasis on private and blended finance instruments for development.

Private finance includes capital formation by the private sector, private credit by banks, market capitalisation, private development assistance, foreign direct investment and other private capital flows. Blended finance, on the other hand, is the strategic use of public finance and philanthropic funds to catalyse private capital flows in developing countries around key development areas. However, the rampant use of private and blended finance essentially implies that private investment can use its discretion to invest in areas where profits are most lucrative and that public resources will be used to leverage private investment — strategies that are not aligned with sustainable development.

Developing countries are currently standing at a tipping point — they face financing gaps betweenUSD 3.3 and USD 4.5 trillion annually to realise the SDGs. Despite the financing deficit however, there's a growing trend of states offering massive tax breaks, exemptions and incentives to multinational corporations, cross-border investment and big businesses.

Tax incentives are policy measures that allow deductions, exclusions and exemptions that reduce the tax liability of select economic entities — enterprises, corporations and firms — with the intention of influencing cross-border investment behaviour, decisions or activities. But a new report by the

Financial Transparency Coalition finds that such tax incentives are largely unnecessary, redundant, inefficient and ineffective. They are the result of the rampant abuse of tax systems, especially in developing countries, that undermine democracy and handicap governments' capacity to adequately tackle inequalities and fully realise human rights.

The power dynamics of tax incentives

Governments, especially in developing countries, offer vast tax incentives as inducements to attract flows of capital into preferred locations or sectors of the economy or to undertake specific investment activities. Their use is justified with the argument that they drive corporate investment in areas and projects that would have otherwise been unprofitable for investors.

However as studies have shown, there isno correlation between tax incentives and investment in the Global South — and their benefits, effectiveness and necessity remain doubtful. In fact, surveys have concluded that foreign investment is instead driven by market size, real income and skill levels in the host country, availability of infrastructure, conducive trade policies and a country's political and macroeconomic stability.

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While the decision to grant tax incentives ultimately rests with sovereign governments, there are a number of institutional and power dynamics within and outside each country that shape its incentive regime. Ostensibly, tax breaks are offered to compete for investment given the increasing financialisation of capital. Their proliferation is a manifestation of international tax competition — countries locked in competition with one another in a bid to attract foreign direct investment by offering more and more generous tax breaks.

The sharp increase in incentives, especially in the Global South, is however also a result of the conditionality attached to structural adjustment programmes led by the International Monetary Fund (IMF) in the 1980s and 1990s, which entailed the implementation of fiscal and non-fiscal incentives to create favourable business climates in developing countries.

Harmful tax incentives are also deeply abrasive given that they exhibit the same features as illicit financial flows (IFFs), flourish in a global financial system that privileges private investment over public finance and are enabled by financial opacity and weak governance. While there's no agreement over the definition and scope of IFFs, they are generally analysed through three lenses — illicit as illegal, illicit as socio-economically adverse and illicit as violating human rights.

How tax incentives do harm

Tax incentives offered without a legal basis are illegal and therefore must be considered illicit. Tax incentives are commonly offered in contravention of laws that specify the criteria to be eligible for tax incentives, the tax treatment that would be given to firms availing incentives, the public bodies that have the authority to grant incentives as well as the processes for enforcement and implementation of incentives. Poorly formulated laws, with unclear rules on enforcement create opportunity for tax abuse. Legal gaps that do not explicitly prevent practices like intra-firm profit shifting, for instance, run the risk of exploitation. Further, the scope of discretion in offering tax incentives by the political class can promote rent-seeking and corruption.

Tax incentives have vastly adverse socio-economic impacts as they result in vast amounts of revenue foregone for governments — potential tax revenue that governments wilfully opt not to collect. This way, they prevent financing for public services, realisation of human rights and addressing inequalities. There is no definitive data on the global magnitude of revenue foregone to tax incentives, as not all countries collect and publicly report such data. Neither is there a standardised methodology to do so. Varied estimates suggest that developing countries lose USD 138bn worth of revenue to incentives each year; Latin American countries lose close to 3 per cent of their GDP to incentives; and countries in Asia lose up to 8.1 per cent of their GDP to tax breaks.

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Finally, tax incentives also threaten the realisation of human rights by way of their impact on public finance, especially when offered in conjunction with promotional packages that include relaxation of labour standards in Special Economic Zones, encroaching on land rights and gender-based discrimination. Incentives offered in opaque and discretionary manners also contravene the freedom of information, transparency, accountability and public participation.

What to do regionally and globally

Curbing harmful tax incentives is crucial and can be done by increasing financial transparency, strengthening governance and deepening international cooperation. Tax incentive regimes must be underpinned by clear, transparent and credible legal, technical and political processes to deter rent-seeking behaviour. Incentives must be justified by their clear link to national developmental strategy, as well as clear beneficial links with socio-economic policies. A cost-benefit analysis covering economic, social, labour and environmental aspects should be regularly conducted for existing as well as new tax incentives, as part of review and monitoring processes.

Moreover, there should be clear limitations specifying the scope of incentives to rule out any room for discretion or loopholes, as well as sunset clauses to address redundant incentives. Countries must also transparently and publicly report on tax expenditures or revenue foregone as a result of incentives. Freedom of information laws must extend to firms using tax incentives.

At an international level, global and regional cooperation bodies must cooperate on the issue of incentives to prevent and stop tax competition. An extraterritorial or spillover analysis of tax incentives granted by a particular country must be undertaken to ensure that sovereign decisions by a state do not impact the sovereignty of another.

Harmful tax incentives flourish because of the current architecture of national and global policies on financial flows, are characterised by poor governance and overly privilege 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.