International Tax Competition, Harmful Tax Practices and the 'Race to the Bottom': A Special Focus on Unstrategic Tax Incentives in Africa

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Abstract
Countries often adopt competitive tax policies to encourage foreign investment or discourage the exodus of investments. However, the tax policies that countries adopt may result in harmful tax competition if they affect another country's tax polices whereby they are forced to adopt lower tax rates to remain competitive. The resultant harmful tax practices can lead to a "race to the bottom" which can ultimately drive applicable tax rates to zero for all countries. In addressing this problem, the OECD BEPS Project concentrated on harmful tax practices by preferential tax regimes. However, in Africa, the pertinent harmful tax practice that leads to the race to the bottom, is the granting of unstrategic tax incentives to foreign investors in the hopes of encouraging foreign direct investment. This article discusses the fiscal challenges of granting unstrategic tax incentives at domestic level and their harmful implications at level which lead to a race to the bottom which poses spill-over effects on other countries. Recommendations are offered to ensure the efficiency and effectiveness of domestic tax incentives by improving on their design, transparency and administration. Recommendations are also offered to prevent the race to the bottom at international level by encouraging tax coordination at the regional level.

INTRODUCTION

Countries compete with each other in a number of ways. They can, for instance, compete for economic activities by offering different mixes of security of ownership, access to resources, regulatory climates, and demands

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on investors.[1] Tax competition is one form of state competition.[2] As states are sovereign jurisdictions that have a right to determine their own tax policy, they can adopt competitive tax policies by which they lure economic activity away from other countries, for example by lowering fiscal burdens (through tax cuts, tax breaks, or tax subsidies) to either encourage the inflow of productive resources or discourage the exodus of those resources.[3]

Tax competition might not be bad if, for example, it counters a political bias towards excessive public expenditure or where it counters governments' tendency to over tax and ensures that tax rates are kept at optimum levels.[4] However, tax policies and tax choices that a country adopts may result in harmful tax competition if they affect another country's ability to choose how to tax and expend resources on behalf of its citizens. This is especially so, when countries engage in 'tax wars' by competing with each other to offer the lowest tax rates so as to lure economic activity to their shores. The resultant harmful tax practices undermine other countries' sovereignty. The underlying policy concern is that such harmful tax practices can lead to a 'race to the bottom', which can ultimately drive applicable tax rates to zero for all countries, whether or not this is the tax policy a country wished to pursue.[5] This ultimately impacts on the fiscal economic development of all the countries in the region.[6]

Concerns about harmful tax practices were brought to the forefront in 1998 when the OECD issued a report on 'Harmful Tax Competition',[7] in which it pointed out that harmful tax practices are encouraged, firstly, by jurisdictions that actively peddle themselves as secretive tax havens for the avoidance of tax that would have been paid in other countries;[8] and secondly, when countries form preferential tax regimes (regimes that ensure low or no taxation of certain incomes) to lure investments to their shores

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1 Andrew Morriss and Lotta Moberg, 'Cartelizing Taxes: Understanding the OECD's Campaign against Harmful Tax Competition' (2012) 14 Colombia Journal of Tax Law 5.

2 The G20 Development Working Group by the IMF, OECD, UN and World Bank, 'Options for Low Income Countries: Effective and Efficient Use of Tax Incentives for Investment' (15 October 2015) 29.

3 Morriss and Moberg (n 1) 9.

4 The G20 Development Working Group (n 2) 29.

5 OECD/G20 BEPS Project, 'Action 5: Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance' (2015) 23.

6 Mindy Herzfeld, 'Defining Multinationals' Fair Share of Tax' Tax Notes International (24 July 2017).

7 OECD, *Harmful Tax Competition Report* (OECD 1998). https://doi.org/10.1787/9789264162945-en

8 OECD, 'Issues in International Taxation No 1' *International Tax Avoidance and Evasion* (1987) 20; Anthony Ginsberg, *International Tax Havens* (2 edn, Butterworths 1997) 5–6; Paul Roper and Julian Ware, *Offshore Pitfalls* (Butterworths 2000) 5.

by levying no or low effective tax rates on income, even if this leads to the depletion of other countries' tax bases.[9]

When the OECD issued its 2013 Action Plan to curtail 'base erosion and profit shifting' (BEPS), it reiterated that harmful tax practices by preferential tax regimes are among the causes of BEPS that leads to the race to the bottom and the depletion of other countries' tax bases.

However, from an African perspective, the pertinent harmful tax practice that leads to the 'race to the bottom' and self-imposed tax base erosion, is the granting of unstrategic tax incentives (ie not well-designed or planned to suit the economic needs of the country) to foreign investors in the hopes of encouraging foreign direct investment (FDI)—a matter that is not addressed in the BEPS Project, but is the main focus of this article.

This article explains the fiscal impact of granting tax incentives at the domestic level, in particular, unstrategic tax incentives, and their harmful implications at international level which lead to a race to the bottom and spill-over effects on other countries. Thereafter recommendations are offered to ensure the efficiency and effectiveness of domestic tax incentives by improving on their design, transparency and administration. At the international level, the article provides recommendations to prevent the race to the bottom by encouraging tax coordination at regional level.

HISTORICAL BACKGROUND: PREVIOUS OECD WORK ON CURTAILING HARMFUL TAX PRACTICES

As noted above, the 1998 OECD report on harmful tax competition pointed out that harmful tax practices can be encouraged by tax-haven jurisdictions and harmful preferential tax regimes.[10] The report noted that tax-haven jurisdictions are characterised by high levels of secrecy in the banking and commercial sectors, and the lack of effective exchange of information with other governments.[11] The report noted that preferential tax regimes, which often occur in high-tax jurisdictions are characterised by the imposition of low or no taxes on the relevant income; the ring-fencing[12] of the regime from the domestic economy; lack of transparency; and the absence of effective exchange of information.[13]

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9 OECD (n 7) para 75; Barry Spitz and Giles Clarke, *Offshore Service* (Butterworths 2002) OECD/3.

10 OECD (n 7) para 75.

11 ibid para 79.

12 The term 'ring-fencing' refers to the use of artificial demarcations that restrict or ignore the application of tax rules to certain transactions (which are inside the ring fence). See Lynette Olivier and Michael Honiball, *International Tax: A South African Perspective* (4 edn, Siber Ink 2011) 579; Christian Schulze, 'The Free-trade Programmes of Namibia and Mauritius and the Latest Developments in Europe: Lessons for South Africa' (1999) XXXII (2) CILSA 202.

13 OECD (n 7) para 75.

However, over the years the OECD failed to address the harmful tax practices of preferential tax regimes.[14] In 2000, in a progress report[15] on the measures that had been taken to identify and eliminate harmful tax practices, the OECD issued a list of tax-haven jurisdictions and called on them to commit themselves to principles of transparency and effective exchange of information. Otherwise they would be regarded as uncooperative tax havens that present a threat, not only to the tax systems of developed and developing countries, but also to the integrity of international financial systems.[16] Under its Global Forum on Transparency and Exchange of Information for Tax Purposes, the OECD only focused on ensuring that tax-haven jurisdictions stop their harmful tax practices[17] by signing Tax Information Exchange Agreements. Many countries (including African countries such as Kenya, Liberia, South Africa and Botswana) underwent the OECD Peer Review process on transparency and exchange of information.[18]

Although the OECD's initiative was successful in promoting transparency and the exchange of information by tax-haven jurisdictions, it generally failed to address harmful tax practices by preferential tax regimes.[19] In its 1998 report, the OECD highlighted eight factors to determine whether a preferential tax regime was harmful. These are cases where a regime had an artificial tax base in that the level of commercial activities in a country was not commensurate with the revenue raised; failed to adhere to international transfer pricing principles; exempted foreign source income from taxation; permitted negotiation with individual taxpayers on the tax rate that would be applicable to them; had high levels of secrecy in banking and commercial sectors which go beyond acceptable confidentiality standards between banks and their clients, thus facilitating tax avoidance; had a wide network of tax treaties which encouraged abuse of tax treaties negotiated with other countries; promoted tax minimisation schemes; and encouraged business operations or arrangements that are purely tax-driven and involve no substantial commercial activities.[20] A regime that was identified as being potentially harmful based on the above factors was considered not to be actually harmful if it did not appear to have created harmful economic

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14 Mindy Herzfeld, 'News Analysis: Political Reality Catches Up with BEPS' *Tax Analysts* (3 February 2014).

15 OECD, *Towards Global Tax Co-operation — Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices* (2000).

16 Brian Arnold and Michael McIntyre, *International Tax Primer* (Kluwer Law International 2002) 122–123; Leslie Samuels and Daniel Kold, 'OECD Initiative: Harmful Tax Practice and Tax Havens' (2000) Taxes 236.

17 Gabriel Makhlouf, 'The OECD List of Un-cooperative Tax Havens' (OECD 2002).

18 OECD, 'Tax Co-operation Towards a Level Playing Field: 2007 Assessment by the Global Forum on Taxation' <http://www.oecd.org/ctp/harmful/taxco-operationtowardsalevelplayingfield-2007assessmentbytheglobalforumontaxation.htm> accessed 9 February 2019.

19 Herzfeld (n 14).

20 OECD/G20 (n 5) 20.

effects. Three issues were considered in making this assessment, namely, whether the tax regime actually shifted activities from one country to the country providing the preferential tax regime, rather than generate significant new activity; whether the presence and level of activities in the host country was commensurate with the amount of investment or income; and whether the preferential regime was the primary motivation for the location of an activity.[21]

In the (abovementioned) 2000 progress report[22] on measures taken to identify and eliminate harmful tax practices, the OECD identified and listed forty-seven jurisdictions with harmful preferential tax regimes according to the criteria contained in the 1998 report.[23] However, holding-company regimes were excluded from the list. These are regimes that encourage setting up of 'holding companies' by investors from other countries. Holding companies are companies that hold the controlling shares in one or more other companies so that they all form part of the same group of companies.[24] The OECD reviewed holding-company regimes in its member countries such as: Austria, Belgium, Denmark, France, Germany, Greece, Iceland, Ireland, Luxembourg, Netherlands, Portugal, Spain, and Switzerland in light of their interaction with tax treaties and applicable domestic law.[25] While stating that holding-company regimes may constitute harmful tax competition, the OECD reached no conclusions on their status as potentially harmful preferential regimes and promised that continuing the work on holding-company regimes and similar preferential regimes would be a high priority of its ongoing work.[26]

OECD BEPS PROJECT

Since the OECD had concluded that holding company regimes may not constitute harmful preferential tax regimes, over the years many countries developed preferential tax regimes that encouraged harmful tax practices.[27] For a long time, countries' tax authorities have known about the harmful tax practices encouraged by these regimes but there was no political will to address the problem.[28] Meanwhile over the years multinational enterprises (MNEs) exploited the situation to erode other countries' tax bases and shift profits to preferential tax regimes. They exploited gaps in the interaction of different tax systems to artificially reduce taxable income or shift profits to low-tax jurisdictions and preferential tax regimes in which little

21 OECD/G20 (n 5) 21.
22 OECD (n 15).
23 ibid para 8 and 11.
24 Olivier and Honiball (n 12) 689.
25 OECD (n 15) para 12.
26 ibid.
27 ibid.
28 ibid.

or no substantial economic activity was performed.[29] The result was that for decades, MNEs have ended up paying little or no corporation tax in the countries in which they did business. This posed serious risks to other countries' tax revenues, tax sovereignty, and tax fairness. It also posed a great risk to the effectiveness of the international corporate tax system.[30]

Faced with budgetary deficits after the 2007/2008 global financial crisis, political will was developed by the G20 at their 2012 Summit to explicitly prevent 'base erosion and profit shifting' (BEPS) and so, they called upon the OECD to address the matter.[31] Thus in 2013 the OECD issued an Action Plan to address BEPS and in 2015 subsequently released a package of fifteen action measures to curtail BEPS. The OECD is of the view that implementing these measures will better align the location of taxable profits with the location of economic activities and value creation.

Action 5 of the OECD BEPS package highlights that harmful tax practices are one of the main cases of BEPS, and that the underlying policy concerns expressed in the 1998 Report regarding the 'race to the bottom' by preferential tax regimes with respect to the mobile income tax base, are as relevant today as they were when the 1998 report on harmful tax competition was issued. The OECD acknowledged that in its successive reports after the 1998 report, it overlooked one important criterion for identifying preferential tax regimes that was pointed out in the 1998 Harmful Tax Completion Report, namely 'lack of economic substance' by preferential tax regimes. The 2013 BEPS Action Plan Report recommended that this area should be revisited both domestically and internationally.

The OECD notes that its work on harmful tax practices is neither intended to promote the harmonisation of income taxes or tax structures generally within or outside the OECD, nor to dictate to any country what should be the appropriate level of tax rates. Rather, its work is about reducing the distortionary influence of taxation on the location of mobile financial and service activities, thereby encouraging an environment in which free and fair tax competition can take place. This is essential in moving towards a 'level playing field' and a continued expansion of global economic growth.[32]

BEPS Action Plan 5 requires countries to revamp the work on harmful tax practices placing priority on firstly, requiring countries that have preferential regimes to ensure that investors carry out substantial business activities and secondly, that they ensure the improved transparency (including compulsory and spontaneous exchange) of tax rulings related

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29 OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013) 8. https://doi.org/10.1787/9789264202719-en

30 OECD, *Addressing Base Erosion and Profit Shifting* (OECD 2013) 9. http://dx.doi.org/10.1787/9789264192744-en

31 G20 Information Centre, 'G 20 Leaders Declaration' (Los Cabos, Mexico 19 June 2012) <http://www.g20.utoronto.ca/2012/2012-0619-loscabos.html> accessed 3 August 2013.

32 OECD/G20 (n 5) 11.

to preferential tax regimes.[33] The requirement for substantial activity for preferential tax regimes is intended to realign taxation of profits with the substantial activities that generate them. The determination of substantial business activity requires examining whether a regime is designed to encourage purely tax-driven operations or arrangements that involve no substantial activities.[34] The test of substantial activity requires that taxpayers undertake core income generating activities.[35]

Concerns about the harmful tax practices of preferential tax regimes do not only exist in OECD countries or in developed countries at large. There are also African countries that have such regimes in place that could engage in harmful tax practices and impact on other countries' tax bases. As pointed out below, most of these regimes have undergone the OECD Global Forum Peer Review Process.

EXAMPLES OF AFRICAN COUNTRIES WITH PREFERENTIAL TAX REGIMES

Mauritius's Headquarter Company Regime

In 1992, Mauritius formed the Offshore Business Activities Authority (MOBAA) to ensure a conducive fiscal environment for the establishment of foreign companies.[36] When MOBAA was phased out in 2001, the Financial Services Development Act 2001 was enacted in terms of which, the Financial Services Commission was established to monitor the country's offshore business activities.[37] In 2007, Mauritius came up with the Financial Services Act under which foreign investors can set up global business corporations that can be licensed as Global Business Licenses (GBL1) which are very popular for the setting up of headquarter companies.[38] Corporate income tax on these companies is currently levied at fifteen percent—reduced from twenty-five percent in 2007.[39] GBL1 companies are exempt from capital gains tax (CGT), dividends withholding tax and interest paid to non-residents.[40] Mauritius' membership in regional bodies, such as the South African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA) and its extensive tax treaty network, particularly with African and Asian countries, encourages foreign

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33 ibid 45.
34 OECD/G20 (n 5) 23.
35 ibid 37.
36 Mark Hampton and Jason Abbot, *Offshore Finance Centres and Tax Havens: The Rise of Global Capital* (St. Martin's Press 1999) 232; Roy Rohatgi, *Basic International Taxation* (Kluwer Law International 2002) 238.
37 Lowtax Network (BVI) Ltd, 'Mauritius: Offshore Business Sectors' <http://www.lowtax.net/lowtax/html/jmuobs.html> accessed 2 June 2018; Schulze (n 12) 43.
38 Thabo Legwaila, 'The Tax Treatment of Holding Companies in Mauritius: Lesson for South Africa' (2011) SA Mercantile LJ 3.
39 ibid 3.
40 ibid 10.

investors from those regions to set up holding companies in that country.[41] In Mauritius, section 159 of Mauritius' Income Tax Act 1995, also provides that any person who derives or may derive any income may apply to the Director General for a ruling as to the application of the Act to that income. The Mauritius Revenue Authority normally issues the ruling within thirty days of the receipt of the application.[42]

In 2011, Mauritius underwent a combined Phase 1 and 2 of the OECD Global Forum peer review process on transparency and exchange of information in tax matters.[43] Some recommendations were made for Mauritius to take a number of actions to improve its regulatory and legal framework and its practice of exchange of information for tax purposes. In 2013, Mauritius asked for a supplementary peer review report. In 2014, the second supplementary peer review report concluded that Mauritius was largely compliant with the standard of exchange of information on request.[44] Mauritius was encouraged to keep making improvements on transparency and exchange of information in tax matters and to provide follow-up reports to the OECD Global Forum.[45]

South Africa's Headquarter Company Regime

South Africa has a regime that is intended to encourage the setting up of headquarter companies. These are companies, whose main purpose is to oversee and provide administrative and management functions associated with a head office, to subsidiaries that are part of a multinational group of companies in a particular region. South Africa's headquarter company regime is intended to enable the country to become a gateway for foreign investment into Africa.[46] In terms of the headquarter regime, certain anti-avoidance rules, such as transfer pricing rules have been relaxed with regard to headquarter companies.[47] In 2012, South Africa went through a combined Phase 1 and 2 of the OECD's Global Forum peer review process, which

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41 Mauritius Offshore Business Activities Authority (MOBAA), 'Mauritius: A Sound Base for The New Millennium' (5 July 1999) <http://www.mondaq.com/article.asp?articleid=7371&searchresults=1> accessed 2 June 2009.

42 Ernest & Young, *Worldwide Transfer Pricing Reference Guide* (2015/16) 212. For the list of Income Tax Rulings that have been issued so far, see Mauritius Revenue Authority, 'Income Tax Rulings' <http://www.mra.mu/index.php/media-centre/rulings> accessed 28 March 2017.

43 OECD, *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: Mauritius 2011—Combined: Phase 1 + Phase 2* (OECD 2011). https://doi.org/10.1787/9789264097230-en.

44 OECD, *Global Forum Second Supplementary Peer Review Report Combined Phase 1 + Phase 2: Mauritius* (OECD 2014) para 12. https://dx.doi.org/10.1787/9789264097230-en

45 ibid para 13.

46 Section 9I of Income Tax 59 of 1962; Oliver and Honiball (n 12) 844

47 Annet Oguttu, 'Developing South Africa as a Gateway for Foreign Investment in Africa: A Critique of South Africa's Headquarter Company Regime' (2011) 36 South African Yearbook of Intl L 61.

indicates that South Africa is considered by its peers to be a reliable and cooperative partner with respect to exchange of information in tax matters.[48] South Africa's headquarter regime is one of those that was reviewed by the OECD and found to be a potentially harmful tax practice, but based on the OECD test, was not actually considered harmful because it was not used to erode other countries' tax bases.[49] The important thing for South Africa is to ensure it continues to balance its international obligations to prevent harmful tax competition with its desire to preserve the competitiveness of its economy.

Botswana's Intermediary Holding Company Regime

In 2003, Botswana formed the International Financial Services Centre (IFSC), to foster the setting up of intermediary holding companies. These are companies incorporated outside the investor's country of residence, interposed between the ultimate holding company and the operating subsidiaries of a multinational group of companies so as to expand investments in new regions.[50] Botswana's intermediary holding company regime is aimed at establishing and developing Botswana as 'a world class hub for cross border financial and business services into the rest Africa.'[51] IFCS companies get favourable tax treatment in Botswana. This includes corporate tax at fifteen per cent instead of the normal twenty-five per cent, exemption from withholding taxes on interest, royalties or dividends; exemption from VAT and CGT.[52] IFSC companies have access to Botswana's tax treaties, which can result in lower withholding taxes.[53] Botswana underwent the OECD Global Forum Phase 1 peer review process and a report was issued on the legal and regulatory framework put in place to ensure transparency and exchange of information for tax purposes in Botswana.[54] Botswana has taken action to address key recommendations made in its Phase 1 peer review. Botswana amended its laws to ensure access to banking information and the confidentiality of information received in connection with its exchange of information processes. It also amended its laws to permit entering into tax information exchange agreements (TIEAs), and has since signed a number of such agreements to allow for exchange of information. Legal reforms were also made with regard to information on trustees and nominees to ensure that the ownership, accounting, and relevant banking information is

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48 OECD, *Global Forum, Peer Review Report: Combined Phase 1 + Phase 2 – South Africa* (OECD 2012) para 10. https://doi.org/10.1787/9789264182134-en

49 OECD/G20 (n 5) 64.

50 Legwaila (n 38) 39.

51 Botswana International Financial Services Centre, 'Annual Report 2009/10' <http://www.ifsc.co.bw/docs/ifsc_annualreport_2010.pdf> accessed 1 July 2017.

52 Ernest & Young, *The 2011 Worldwide Corporate Tax Guide* (2011) 129.

53 Botswana International Financial Services Centre (n 44) 13.

54 OECD, *Peer Review Report of Botswana - Phase 1: Legal and Regulatory Framework* (OECD 2010). https://doi.org/10.1787/9789264095472-en

available according to the OECD standards.[55] In 2016, Botswana underwent Phase 2 of the review, which noted that overall the country was largely compliant with the international standard. The country was called upon to keep on monitoring the ownership entities and to ensure that all accounting information, including underlying documentation, is retained for all entities and arrangements; and that its exchange of information (EOI) agreements are brought into force expeditiously. Subsequently, Botswana created a dedicated unit and a detailed process to manage exchange of information requests. However, this has not been tested in practice.[56]

Liberia's Shipping Regime

The Liberian Shipping Registry is administered by the Liberian International Ship and Corporate Registry and is recognised globally as the most tax-effective offshore corporate registry in the world.[57] Vessels in the Liberian Registry are taxed annually at a fixed fee based on the net tonnage of the vessel. Similarly, Liberian corporations are taxed at a fixed annual tax. Taxes on operations and profit are not assessed.[58] In 2012, Liberia underwent Phase 1 of OECD' Global Forum peer review. It was required to address concerns regarding ownership and identity information as well as its accounting records. Subsequently, the government took active steps to improve compliance. Liberia amended its legislation in line with the recommendations made in its peer review report to ensure improved compliance with ownership information and to fully comply with recommendations for accounting records.[59] Liberia has also signed TIEAs with a number of jurisdictions.[60]

It should be noted that the focus of the above reviews was mainly on transparency standards, but did not address the preferential tax regimes themselves. This implies that regimes that were assessed by the Global Forum before the substantial activity requirement in Action 5 of the BEPS Report was developed, may need to undergo additional review and possible amendment of certain regime features. However, African countries with regimes such as the above, are very hesitant to adopt the

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55 OECD, Peer Review Report of Botswana – Phase 1: Legal and Regulatory Framework (OECD 2010). https://doi.org/10.178/978264095472-en

56 OECD, *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: Botswana – Phase 2* (OECD 2016). https://doi.org/10.1787/9789264250734-en

57 Caroline Doggart, 'Tax Havens and Their Uses' (1990) Special Report No 1191, The Economist Publication 53.

58 Official Guide to Ship and Yacht Registries, 'Liberia' <https://www.guidetoshipregistries.com/sample/liberia> accessed 8 March 2017.

59 The Africa Report, 'Liberia: Africa's Unknown Tax Haven with Much to Lose' (28 April 2016) <http://www.theafricareport.com/West-Africa/liberia-africas-unknown-tax-haven-with-much-to-lose.html> accessed 8 March 2017.

60 OECD Global Forum 'Supplementary Peer Review Report – Phase 1 Liberia' (2016) paras 7–10 <http://www.oecd.org/tax/transparency/global-forum-supplementary-report-liberia.pdf> accessed 21 February 2019.

OECD recommendations since this would affect the competiveness of their economies in attracting badly needed foreign direct investment.

THE PERTINENT HARMFUL TAX PRACTICE IN AFRICA: GRANTING UNSTRATEGIC TAX INCENTIVES

In most African countries though, transparency issues pertaining to preferential tax regimes are less of a problem since most of them are high tax countries. The most important concern for African countries is the granting of unstrategic tax incentives which has led to a race to the bottom in Africa, as governments compete with each other in coming up with the most attractive tax incentives that will attract foreign investors to their shores rather than to other countries in the region.[61] Often, the pressure to offer incentives stems from an awareness of those offered by other countries. Many tax incentives granted by African countries are unstrategic as they are not well designed or planned to suit the economic needs of those countries. This results in spill-over effects that impact on other countries' tax bases.[62]

The tax base erosion risks that arise when one country offers tax incentives to foreign investors are, however, not part of the OECD BEPS Project. Instead, the matter was dealt with by the G20 Development Working Group in conjunction with the OECD, the International Monetary Fund (IMF) and the World Bank in the form of 'toolkits', which are essentially a side project intended to assist low-capacity developing economies in addressing BEPS concerns that are of priority to them.[63]

Definition of Tax Incentives and how to Identify a Tax Incentive in a Tax Code

Tax incentives have been defined as 'any tax provision granted to a qualified investment project that represents a favourable deviation from the provisions applicable to investment projects in general'.[64] A tax incentive can be spotted in a country's tax code, if there are provisions that result in tax not being levied or tax being levied at a reduced tax rate. Tax incentives in countries' tax codes can take several forms. Examples include: tax free zones (designated areas in which specified businesses are exempt from customs duties and other indirect taxes); tax holidays (complete exemption from tax for a limited duration); and preferential tax rates (reduced tax rates or tax credits for certain investment expenditures).[65] Such provisions that

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61 Alex Easson, *Tax Incentives for Foreign Direct Investment* (Kluwer International 2004) 1–2; James Hines Jr, 'Tax Sparing and Direct Investment in Developing Countries' in James Hines (ed), *International Taxation and Multinational Activity* (University of Chicago Press, 2001) 40.

62 Easson (n 61) 1–2; Hines (n 61) 40.

63 The G20 Development Working Group (n 2) 6.

64 ibid 7.

65 ibid 8.

grant tax incentives are prevalent in the tax codes of most countries all over the world. The difference is with respect to the type of tax incentives used. High income countries tend to rely more on granting tax credits for investment and favourable tax treatment of research and development (R&D); low income countries rely more on offering tax holidays (complete exemption from tax for a limited duration) and reduced tax rates; whereas middle income countries rely more on offering preferential tax zones (where favourable treatment applies to investments in the zones).[66] Ultimately the choice of different incentives adopted, depends more on the economic developmental needs of the countries concerned.

The Scope Tax Incentives Covered

The focus of this article is on investment tax incentives that relate to corporate income tax. This excludes: tax incentives related to indirect takes e.g. sales tax, value added tax or other trade tariffs; and grants, in-kind benefits or loan guarantees, which could mimic the effects of tax incentives but are usually designed differently and subject to different governance procedures. The article also excludes a discussion of tax exemptions (whereby a taxpayer is excluded from tax or where certain types of income are excluded from tax subject to certain conditions), which also undermine revenue collection in African countries, complicate tax systems, and open the door to political interference and corruption.[67]

Why do Countries Grant Tax Incentives?

The primary motivation for granting tax incentives is to stimulate investment by attracting foreign direct investment (FDI), which often contributes to a country's overall economic development. Indeed, some empirical studies have found positive correlations between inward FDI and economic growth, even though conclusions about causality remain contentious.[68] Tax incentives have been noted to promote specific economic sectors or certain types of activities as part of an industrial development strategy or to address regional development needs.[69]

The resultant FDI inflows can yield various social benefits, such as: capital injection, job creation, knowledge and technology transfer, new management practices, and an increase in the efficiency of domestic markets.[70] Studies have for instance, found significant knowledge transfers

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66 The G20 Development Working Group (n 2) 8.

67 Roy Culpeper and Aniket Bhushan, 'Why Enhance Domestic Resource Mobilisation in Africa?' (2010) 9 (6) Trade Negotiation Insights 35.

68 Samuel Adams, 'Foreign Direct Investment, Domestic Investment, and Economic Growth in Sub-Saharan Africa' (2009) 31 Journal of Policy Modeling 939–949.

69 The G20 Development Working Group (n 2) 6.

70 Samuel Bwalya, 'Foreign Direct Investment and Technology Spillovers: Evidence from Panel Data Analysis of Manufacturing Firms in Zambia' (2006) 81 Journal of Development Economics 514–526.

from foreign to local firms as well as other positive spill-overs on domestic firms that supply or purchase products from the foreign entity.[71]

Granting Strategic Tax Incentives Strategically

The granting of tax incentives is a sovereign right of nations, which are free to determine their own economic and fiscal policies. The granting of tax incentives will inevitably result in tax foregone which can narrow a country's tax base.[72] Even though a country may want to raise taxes so as to fund the building of its infrastructure and to fund the provision of government services, it may also want to design its fiscal policies to attract FDI that would ensure economic development and thereby create jobs; gain know-how; and improve access to its natural resources. It may therefore use its tax codes to attract FDI in designated development areas by strategically granting tax incentives to foreign investors to develop certain development projects in specific sectors of the economy, thus giving up tax revenue maximisation for the sake of achieving those developmental objectives.

The granting of tax incentives should, however, be done strategically. Thus, a strategic tax incentive is one that is effective in contributing to a country's economic development and improves living conditions for its citizens.[73] This is the case if the tax incentive results in new job creation and boosts productivity that spills over into the domestic economy.[74] In addition, a tax is considered strategic if its governance is efficient in ensuring that the revenue forgone is commensurate with developmental objectives envisaged. When granting tax incentives, countries should understand that the public revenue forgone as a consequence of tax incentives is in fact an implied tax expenditure. To ensure efficiency, it has been recommended that tax incentives should be offered for activities that are more mobile with less tax-sensitive bases, as tax has a lesser impact on whether or not to invest in a given country.[75]

Unstrategic Tax Incentives

Tax incentives are unstrategic when they are inefficient and counterproductive, whereby their costs exceed the social benefits.[76] This is the case, when a nation gives up more revenue than necessary to achieve some development

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71 The G20 Development Working Group (n 2) 14–15; Beata Smarzynska Javorcik, 'Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages' (2004) 94 (3) Economic Review 605–627; Ann Harrison and Andrés Rodríguez-Clare, 'Trade, Foreign Investment, and Industrial Policy for Developing Countries' in *Handbook of Development Economics* (Elsevier 2010).

72 IMF, 'Kenya, Uganda, and United Republic of Tanzania: Selected Issues' IMF Country Report No 08/353 (2008).

73 The G20 Development Working Group (n 2) 9.

74 IMF (n 72) 8.

75 The G20 Development Working Group (n 2) 19.

76 ibid 9.

objectives or when the same development objectives could have been achieved with a smaller revenue sacrifice. The following are some of the indicators of a tax incentive that is unstrategic and inefficient.

Tax incentives that do not attract FDI

A tax incentive is unstrategic if it does not attract the envisaged FDI. Even though some empirical studies on the relationship between effective tax burdens and FDI generally conclude that host country taxation significantly affects investment.[77] These studies refer mainly to investments in developed countries. In developing countries, the effects of tax on investment is generally smaller.[78]

Redundant tax incentives

Granting tax incentives can be unstrategic if the investor had invested without the offer of the tax incentive, which makes such a tax incentive redundant.[79] A tax incentive can also be rendered unstrategic when it is targeted at new investors, but is sought by businesses outside the target group.[80]

Tax incentives that distort resource allocation

Although the economic theory is that tax incentives act as a tool for encouraging FDI, a tax incentive can be unstrategic if it distorts resource allocation leading to sub-optimal investment decisions, which are harmful to long term economic growth.[81] Distortions can also result in competitive disadvantages for non-incentivised sectors. Where labour and capital are diverted to incentivised firms in response to discriminatory tax treatment, this can distort the allocation of resources and can hurt economic growth.[82]

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77 Ruud De Mooij and Sjef Ederveen, 'Corporate Tax Elasticities: A Reader's Guide to Empirical Findings' (2008) 24 Oxford Review of Economic Policy 680–697.

78 Sebastian James and Stefan van Parys, 'Investment Climate and the Effectiveness of Tax Incentives' (2009) World Bank Group; Ali S Abbas and Alexander Klemm, 'A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies' (2013) 20 International Tax and Public Finance 596–617.

79 The G20 Development Working Group (n 2) in the 'Executive Summary'.

80 OECD, 'Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries' (2014) <http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf> accessed 17 June 2015.

81 Alicja Brodzka, 'Tax Incentives in Emerging Economies' (2013) 3 (1) Business Systems and Economics 27.

82 The G20 Development Working Group (n 2) 19.

Where the costs of administering the tax incentive outweigh the advantages

If a country grants a tax incentive, resources are required to ensure that businesses comply with the requirements of granting that tax incentive.[83] Where labour and various expenses become costly, compared to the advantages the tax incentive was expected to provide, such a tax incentive may be quite unstrategic, considering the revenue already foregone. These administrative costs are especially pertinent in developing countries where administrative capacity is often limited; and scarce resources might be diverted away from core aspects of a country's tax administration.[84]

Tax incentives that discourage domestic investment

A tax incentive can be unstrategic if it is granted to foreign investors in a certain field and discourage domestic investors in a similar field. This gives foreign investors competitive advantages over small and medium enterprises that operate at domestic level.[85] In response, domestic investors may resort to abusing the tax incentive regime. For example, local firms may use foreign entities to route their local investments in order to qualify.

Tax incentives can encourage tax abuse

A tax incentive is unstrategic if it creates unintended tax-planning opportunities leading to further revenue leakages. This could be the case where a tax incentive enables opportunities for profits and deductions to be artificially shifted across entities with different tax treatments either domestically or internationally.[86] Similarly a tax incentive is unstrategic if it results in rent-seeking, corruption, and other undesirable abusive activities.[87]

Factors that Cause Granting Unstrategic Tax Incentives

Lack of a cost-based analysis of tax incentives

Unstrategic tax incentives are often granted if there is inadequate analysis of their costs and benefits in a national context to support government decision-making. This is also the case where there is no readily available information on the lists of tax incentives or reporting on who the beneficiaries are.[88]

Governance issues

Tax incentives may be unstrategic if they are granted outside a country's tax laws, if they are administrated under multiple pieces of legislation and

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83 IMF (n 72) para 15.
84 The G20 Development Working Group (n 2) 16.
85 Alexander Klemm and Stefan Parys, 'Empirical Evidence on the Effects of Tax Incentives' (2012) 19 International Tax and Public Finance 393–423.
86 OECD (n 80) 2.
87 Klemm and Parys (n 85) 393–423.
88 OECD (n 80) 2.

if they are administered by different government ministries that do not coordinate their incentive measures with each other or with the national revenue authority. This may result in governance overlap, inconsistency in administrative measures, and even ministries working at cross-purposes.[89]

The assumption that foreign investors can only get relief from taxes through tax incentives

The assumption that granting tax incentives is the only way to give foreign investors relief from tax so as to encourage them to invest in a given country, encourages the granting of unstrategic tax incentives. This assumption is misplaced as MNEs can get relief by granting them direct subsidies (to for example support research and development) which provide a financial benefit rather relief from tax.[90]

Tax-sparing provisions in tax treaties

Due to the fact that most African countries employ the territorial system of taxation, in that only income derived within their borders is taxable, the benefit of the tax incentives they offer to foreign investors may be limited; for example, if such countries have entered into double tax treaties with developed countries that employ the worldwide system of taxation to tax their residents. If the investors' home country grants a tax credit for foreign taxes paid (in order to prevent double taxation) but the investor paid no foreign taxes as a result of a tax incentive, that foreign investor would not be availed a tax credit and would have to pay the taxes due in their home country. This implies that the benefit of the tax incentive might be lost in increased tax payments in the investor's home country. To prevent this, developing countries often insist on including tax-sparing provisions in their treaties,[91] which require the investor's country of residence to allow their residents to retain the advantages of tax incentives provided by those countries, by essentially sparing the taxation of foreign source income of such resident.[92]

The push to include tax-sparing provisions in tax treaties can, however, intensify tax competition among developing countries and the granting of unstrategic tax incentives so as to attract FDI.[93] Tax sparing can also provide

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89 OECD (n 80) 2.

90 Isabel Busom, Beatriz Corchuelo and Ester Martínez Ros 'Tax Incentives and Direct Support for R&D: What do Firms Use and Why?' Universidad Carlos III de Madrid (2013) Working Paper Business Economics Series WP-11-03.

91 United Nations, *UN Handbook on Selected Issues on Administration of Double Tax Treaties for Developing Countries* (UN 2013) 35.

92 Annet Oguttu, 'The Challenges of Tax Sparing: A Call to Reconsider the Policy in South Africa' (2011) 65 (1) Bulletin for International Taxation <http://online.ibfd.org/kbase/>; Hines (n 54) 40.

93 The G20 Development Working Group (n 2) 32.

significant scope for transfer pricing, round tripping,[94] and treaty shopping[95] both in the country of the investor and in the country of the investment.[96] Tax sparing inevitably results in a direct loss of revenue for the foregone tax. In practice, developing countries often have to make concessions to obtain tax sparing. They are, for instance, forced to grant developed countries favourable withholding taxes and higher thresholds for taxing permanent establishments in the source country.[97] To prevent this kind of tax abuse, the 1998 OECD Report on Tax Sparing sets out several recommendations that have been included in the OECD Model Tax Convention on Income and on Capital.[98]

Tax incentives in bilateral investment treaties

A bilateral investment treaty (BIT) is a treaty between two states that protects investments by investors of one state in the other state.[99] Tax incentives in BITs vary widely in form and there is no standard template. Although BITs often exclude tax matters, the 'most favored nation clause'[100] in BITs might unintentionally accord benefits to other taxpayers not originally intended to benefit from the tax incentive. Moreover, protections under the BIT, such as stabilisation clauses,[101] may make it hard to withdraw the tax incentive when it no longer serves the original purpose, or may require compensation not otherwise payable. The other concern is that BITs can open up opportunities to shop for forums to resolve disputes that would arise from tax related disputes. This was a cause of concern in the Ugandan case of *Heritage & Gas Limited v Uganda Revenue Authority,*[102] in which the taxpayer who lost the case, which was based on double tax treaty issues, decided to seek a resolution of the tax dispute under the BIT, which has an arbitration clause (unlike the case in the tax treaty). The case was taken for arbitration to London under the United Nations Commission on International Trade Law,[103]

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94 This is a tax-avoidance scheme which involves the transfer of funds between or among parties, which directly or indirectly results in a tax benefit and significantly reduces, offsets or eliminates any business risk incurred by any party.

95 The use of double tax treaties by the residents of a non-treaty country in order to obtain treaty benefits that are not supposed to be available to them.

96 Arnold and McIntyre (n 16) 53.

97 OECD, *Tax Sparing: A Reconsideration* (1998) 21–30; Jeffrey Owens and Torsten Fensby, 'Is There a Need to Re-evaluate Tax Sparing' (1998) 16 Tax Notes International 1447.

98 OECD (n 97) 35–36.

99 Kenneth Vandevelde, 'The Economics of Bilateral Investment Treaties' (2000) 41 Harvard Intl LJ 469.

100 Rudolf Dolzer and Christoph Schreiber, *Principles of International Investment Law* (Oxford University Press 2008) 184.

101 Howard Mann, 'Stabilization in Investment Contracts: Rethinking the Context, Reformulating the Result' (2011) *Investment Treaty News* <http://www.iisd.org/itn/2011/10/07/stabilization-in-investment-contracts-rethinking-the-context-reformulating-the-result/>

102 Tax Appeals Tribunal Tax Application No 26/2010.

103 *Tullow Uganda Ltd v Heritage Oil and Gas Ltd, Heritage Oil plc* [2013] EWHC 1656 (Comm).

which deals with investment disputes and was decided in Uganda's favour. These issues are best considered in collaboration with those responsible for negotiating the investment treaties.[104]

ADDRESSING UNSTRATEGIC TAX INCENTIVES AT THE DOMESTIC LEVEL

A number of academic articles have been written about the ineffectiveness and inefficiency of tax incentives and the associated abuse and corruption.[105] They have recommended the reform of tax-incentive regimes by removing unstrategic tax incentives or improving their design, transparency, and administration. Yet there has been reluctance to scale back incentives; instead, there has been a tendency for them to proliferate, as there are usually various vested interests, political inertia, and tax competition with other countries involved.[106] This is because the granting of tax incentives is not driven by tax considerations alone, or by well-articulated economic concerns that are aimed at improving the wellbeing of citizens, but they are also driven by political motivations.[107] For instance, politicians may find it attractive to introduce new tax incentives to reveal their proactive stance in addressing weak economic performance, or to favour particular regions. Vested interests in certain tax incentives by businesses and some government officials may also make it difficult to have such incentives repealed, even if they may be ineffective.[108] Businesses often influence the governance and design of tax incentives to suit their objectives, and they often become powerful lobbyists who can capture the political process to resist change.[109]

In 2011, the IMF, OECD, UN and World Bank stated in their joint report to the G20 that there was a need to support effective tax systems in developing countries to ensure efficient and effective use of tax incentives for investment.[110] Consequently, in 2015, the G20 Development Working Group in conjunction with the OECD, the IMF and the World Bank, published a 'Toolkit for tax incentives'[111] which can be helpful in preventing the granting of unstrategic tax incentives. The toolkit sets out the following guidance for the design and governance of tax incentives and also recommendations to

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104 The G20 Development Working Group (n 2) 32.

105 Howel Zee, Janet Stotsky and Eduard Eduardo, "Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries" (2000) 30(9) World Development 6.

106 ibid 6.

107 ibid 28.

108 ibid.

109 Terry Moe, 'Power and Political Institutions' (2005) 3 Perspectives on Politics 215–233.

110 IMF, OECD, UN and World Bank, *Striking the Right Balance between an Attractive Tax Regime for Domestic and Foreign Investment, by Using Tax Incentives for example, and Securing the Necessary Revenues for Public Spending, is a Key Policy Dilemma* (IMF Policy Paper 2011).

111 The G20 Development Working Group (n 2) 6.

prevent the spill-over effects of tax incentives that lead to the 'race to the bottom' in an international context.[112]

Guidance on the Design of Tax Incentives

The design of tax incentives is critical to their effectiveness and efficiency. The G20 Development Working Group recommends that policies relating to tax incentives should involve three core design issues:

The choice of tax instrument to incentivise investment

There are various tax instruments that can be used to grant a tax incentive. This can include the use of a wide range of taxes, such as corporate income tax, VAT, tariffs, property taxes, personal income taxes, and social contributions.[113]

A country may also have to choose between cost-based and profit-based tax incentives. Cost-based tax incentives involve specific allowances linked to investment expenses, such as accelerated depreciation schemes and special tax deductions and credits. They are targeted at lowering the cost of capital, thus ensuring that investment projects are more profitable at the margin thereby encouraging investments that would not otherwise have been made. Profit-based tax incentives generally reduce the tax rate applicable to taxable income. Examples include tax holidays, preferential tax rates, or income exemptions. The main disadvantage is that government revenue is foregone in order to make investment projects more profitable, which in some cases would have been undertaken even without the incentive.

Eligibility criteria used in the selection of qualified investments

Developing criteria to select investments helps identify the types of investment that a government seeks to attract and reduce the fiscal cost of incentives. The selection can be based on: the size of the investment, the sector of investment, or by targeting special regions/zones.[114]

Provisions to monitor life cycle of investments

It is very important that after approval, the tax administration should continue monitoring investments throughout their life cycle stages. Often this matter is neglected in many countries.[115] It is important that taxpayers are required to file a tax return so that the authorities can assess the revenue cost of the incentive. Tax authorities should periodically carry out audits to ensure that tax incentives are not abused. Tax authorities should also audit to ensure that the conditions attached to incentives are fulfilled.[116]

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112 The G20 Development Working Group (n 2) 6.
113 IMF (n 72) para 3.
114 The G20 Development Working Group (n 2) 23.
115 ibid.
116 ibid.

Sunset provisions

Making tax incentives temporary rather than permanent provides for a natural point of evaluation, ensuring a periodic reconsideration of whether the incentive should be continued, reformed, or repealed.[117]

Guidance on the Governance of Tax Incentives

Governments' decisions about tax incentives, its policies and administration must be transparent and subject to scrutiny and evaluation to ensure accountability for actions taken. This would limit the scope for corruption, strengthen the trust of investors in government and enhance confidence in the public in the tax system.[118] The G20 Development Working Group recommends the following key requirements for good governance of tax incentives:

The awarding and monitoring of incentives should be guided by the rule of law

Two general approaches are applied in the administration of tax incentives: a rules-based system and a discretionary system. Under a rules-based system, the decisions about to whom, under what conditions and in what form to provide incentives are based on statutory provisions. Under a discretionary system, the incentives are granted on an *ad hoc* basis by government agencies and officials. It is recommended that a rules-based system be adopted, as it limits the room for misuse and corruption.[119] This implies that tax incentives must be approved by the legislature and appropriate parliamentary and public scrutiny. To ensure transparency and accessibility, tax incentives must be consolidated into the main body of the tax law and not spread in multiple pieces of legislation that are outside the tax laws. The law should specify the criteria and conditions that the taxpayer needs to satisfy in order to qualify for a tax incentive.

Transparency of tax incentives

Transparency is fundamental to empowering all stakeholders (the legislature, businesses, civil society, and the public at large) with information about tax incentive policies, so that they can hold government accountable for its decisions. It is important that transparency is created along the following three dimensions. Firstly, there should be legal transparency, in that tax

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117 US Department of the Treasury, 'The Case for Temporary 100 Percent Expensing: Encouraging Business to Expand Now by Lowering the Cost of Investment – A Report by the US Department of the Treasury's Office of Tax Policy' (2010).

118 The G20 Development Working Group (n 2) 23.

119 IMF (n 72) para 34.

incentives should have a statutory basis in relevant tax laws.[120] Secondly, there should be economic transparency, in that the rationale for tax incentives should be clearly spelled out to enable a public debate on the country's policy priorities. Thirdly, there should be administrative transparency, in that the criteria for qualifying incentives should be clear, simple and specific, so as to reduce the discretion of officials that grant the incentives. [121]

Coordination of agencies granting tax incentives

It is critical that ministries and agencies involved in the granting of tax incentives coordinate their activities. Such ministries include the Ministry of Finance, Agriculture, Tourism, or Mining, as well as Investment Promotion Agencies. These different players often bring specific expertise, which can be useful in the design of tax incentives, but they usually have different objectives. For instance, investment promotion agencies often support tax incentives in order to attract investors but they have little direct concern for the revenue consequences.[122] The Ministry of Finance, in contrast, ensures that the revenue needs of the country are taken into consideration. The ultimate and sole authority to enact tax incentives at the national level should therefore be with the Minister of Finance as they are best placed to weigh the different priorities while also keeping an eye on the cost of incentives. [123]

The administration of tax incentives

The G20 Development Working Group recommends that revenue administrations should be in charge of the implementation and enforcement of tax incentive schemes as it has the unique authority, expertise, and experience necessary for the execution of the tax law of which incentives should be part.[124]

ADDRESSING THE IMPACT OF UNSTRATEGIC TAX INCENTIVES AT THE INTERNATIONAL LEVEL: HARMFUL TAX COMPETITION AND THE RACE TO THE BOTTOM

Granting tax incentives in general, and in particular unstrategic tax incentives not only creates negative fiscal implications at domestic level but it also creates harmful implications at international level which lead

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120 Francisca Nierum, 'Reflection on the Attitude of the Courts to Tax Incentive Mechanism in Nigeria' (2011) NIALS Journal of Business Law <http://www.nialsnigeria.org/journals/Dr.Francisca%20E.%20Nlerumbus.pdf> accessed 21 February 2019.

121 The G20 Development Working Group (n 2) 24.

122 Atsu Amegashie, 'Ghana's Regime of Exemptions from Taxes and Duties: Guidelines for Reform' (2011) Department of Economics, University of Guelph, Canada.

123 The G20 Development Working Group (n 2) 27.

124 The G20 Development Working Group (n 2) 28.

to a race to the bottom which poses spill-over effects on other countries. Often this translates into governments perceiving that investors would choose neighbouring countries, thus triggering strategic reactions to offer similar policies. This 'collective action' problem can cause a 'race to the bottom', with all countries ultimately ending up with lower tax revenue and with no discernible impact on the allocation of investment—which makes countries in a region collectively worse off.[125] This in turn poses economic burdens at the regional level, as competing countries put in place matching measures with the risk that ultimately all countries will lose from the use of tax incentives. The race to the bottom is evident among special regimes in Africa, where effective tax rates have fallen to almost zero in industries where special regimes are in place.[126]

In addition, tax incentives produce costs not only in the country that induced them but also for other countries, with the result that the tax incentive may cause more loss than gain. Thus, even if one country could be better off by providing certain strategic tax incentives (other things being equal), nonetheless, all the other countries would be better off if none of them provided tax incentives than if all of them do. The ideal solution to ensure economic development for all countries in the region is for them to think collectively in the way they shape their tax codes and the design of their tax incentives. This collective approach will ensure that countries in the region do not introduce tax incentives whose costs for the whole region exceed the benefits for the country providing them. The collective approach would ensure that if the countries in the region chose to introduce tax incentives that the design of the same is such that it ensures the attraction of capital, the creation of jobs, gaining know-how, accessing natural resources and the development of infrastructure in the region as a whole.

The IMF has long stressed the pervasiveness of the tax incentives in developing countries due to the spill-over reaction to tax policies pursued in other countries.[127] At the UN Third International Conference on Financing for Development in Addis Ababa July 2015, national leaders noted that although tax incentives can be an appropriate policy tool, countries need to engage in voluntary discussions on tax incentives in regional and international forums to prevent resultant harmful tax competition. [128]

Tax Coordination

To resolve the collective action problems that emanate from tax incentives at the domestic level (in particular unstrategic tax incentives) and their

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125 OECD (n 73).

126 Abbas and Klemm (n 78) 596–617.

127 IMF, *Spillovers in International Corporate Taxation* (2014) 7.

128 UN, 'Outcome Document of the Third International Conference on Financing for Development: Addis Ababa Action Agenda' (July 2015) para 27.

harmful impact at international level, coordination and cooperation between states, so that they reach agreement not to engage in 'the race to the bottom'. The G20 Development Working Group asserts that tax coordination offers opportunities to address the harmful spill-over effects of tax competition that are induced by uncoordinated tax design.[129] Tax coordination can for instance take the form of countries agreeing on a non-binding code of conduct not to use certain tax incentives, such as tax holidays. Tax coordination could also be in the form of a common legislative framework regarding certain tax incentives[130] or in the form of cooperation among producers of specific natural resources.[131]

Tax coordination in the East African Community

In 1999, a treaty establishing the East African Community (EAC), comprising Kenya, Tanzania, and Uganda, was formed. Following on this treaty in February 2005, the EAC Customs Union was also formed[132] and gradually EAC members made progress in harmonising their corporate tax rates. However, there has not been much progress in the harmonisation of investment incentives.

Over the years, the EAC countries have expanded their investment incentives. Tanzania has been increasing its number of Special Economic Zones (SEZs)[133] and Kenya continues to provide tax holidays to companies operating in its export processing zones (EPZs)—secured territory where a special tax regime and other conditions are applied to companies operating there.[134] Even though Uganda eliminated tax holidays in 1997,[135] it is under pressure to establish its own EPZs and to provide more generous incentives to investors to match the investment incentives provided by Kenya and Tanzania.[136] There is also increased pressure for tax holidays in EAC countries in response to competition for foreign investors from non-EAC countries. The increased competition over FDI and growing pressure to provide tax holidays and other investment incentives to attract investors could result in a race to the bottom that would eventually hurt all three EAC members.[137]

In 2008, the IMF recommended that a coordinated approach to providing tax incentives in general should become a priority in the EAC.[138] To facilitate closer regional economic integration and to prevent the damaging

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129 The G20 Development Working Group (n 2) 2.
130 ibid 6.
131 ibid 30.
132 IMF (n 72).
133 ibid para 22.
134 ibid para 14.
135 ibid para 38.
136 ibid para 8.
137 ibid para 38.
138 ibid para 32.

uncoordinated contest to attract foreign investors, the EAC members should seek a closer coordination of investment and tax policies. The IMF also recommended that the EAC countries should agree on a Code of Conduct for Investment Incentives and Company Income Taxation. Such a code could provide a framework for consultation and coordination, it could place limits on what kinds of investment incentives could be offered, and it could incorporate standard guarantees to investors, including the freedom to invest, non-discrimination, national treatment, repatriation, and limited expropriation.[139]

A code of conduct on the use of tax incentives for the EAC was subsequently drafted, however, it has not yet been adopted as the signatures required for the code to enter into force have been pending for years. In 2016, the Tax Justice Network[140] called on the EAC to accelerate the harmonisation of its tax legislation by ratifying the East African Code of Conduct on Harmful Tax Competition.

Tax coordination in the West African Economic and Monetary Union

In the West African Economic and Monetary Union (WAEMU), considerable effort has been made to set-up a structure to tackle tax competition by issuing directives that limit the applicable tax rates that countries can use. Coordination of investment incentives has also been pursued in the WAEMU.[141] The coordination framework has led to some convergence of countries' tax systems, and in turn to positive revenue effects in WAEMU member states.

However, there are large gaps between *de jure* and *de facto* coordination, as WAEMU has failed to provide its member states with the necessary resources to undertake effective surveillance, which has led to ineffective enforcement and undermined the credibility of coordination. In fact, the framework allows for unfettered tax competition as long as this is done outside the countries' main tax laws. This has made their tax systems opaque, has increased complexity, and has contributed to a culture of tax negotiation.[142]

Tax coordination in the SADC Region

The Southern African Development Community (SADC) aims to reduce and ultimately to eliminate tax competition that damages the region's revenue

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139 IMF (n 72) para 34.

140 Tax Justice Network, '*Still Racing Towards the Bottom? Corporate Tax Incentives in East Africa' (18 June 2016).*

141 IMF (n 72) para 26.

142 Mario Mansour and Grégoire Rota-Graziosi, 'Tax Coordination, Tax Competition, and Revenue Mobilization in the West African Economic and Monetary Union' (2013) IMF Working Paper No 13/163 (International Monetary Fund).

mobilisation efforts. The SADC Protocol on Finance and Investment provides for cooperation and coordination of legislation pertaining to tax incentives so that the economic policies of member states are not prejudiced.[143]

In terms of the SADC a 'Memorandum of Understanding on Cooperation in Taxation and Related Matters' (the SADC MOU) which was entered into in 2002,[144] member states committed themselves to preventing harmful tax competition in the region. They came up with measures to ensure coordination and cooperation so that tax incentives do not encourage harmful tax competition in the region and to address the negative consequences of tax incentives. In terms of article 4(3) of the MOU, member states committed to ensure that in the treatment and application of tax incentives, they will avoid harmful tax competition as may be evidenced by zero or low effective rates of tax; lack of transparency; lack of effective exchange of information; restricting tax incentives to particular tax payers such as non-residents; promotion of tax incentives as vehicles for tax minimisation; or the absence of substantial activity in the jurisdiction to qualify for a tax incentive. Member states also committed to not introduce tax legislation that prejudices another member state's economic policies, activities, or the regional mobility of goods, services, capital or labour.

Under article 4(1) of the MOU, member states are committed to endeavour to achieve a common approach to the treatment and application of tax incentives and will, amongst other things, ensure that tax incentives are provided for only in tax legislation. Many member states have passed similar investment Acts that offer specific tax incentives and signed mutual beneficial agreements that lighten taxation on businesses.[145] This has encouraged cooperation among these states, which allows the SADC region to promote the integrated region (not specific countries) as attractive for investment. This in turn provides investors with confidence in the SADC region as a whole.

However, with increasing international trade, many SADC member states have bilateral tax agreements with other nations inside and outside the SADC region, which may create situations where one member state may unknowingly create a tax regime that could be detrimental to development in another state. For this reason, the SADC MOU advises all SADC member countries to agree collectively on a Model Tax Agreement that acts as a common policy for dealing with international partners. Member states have

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143 SADC, 'Memorandum of Understanding on Cooperation in Taxation and Related Matters' (2002) <http://www.sadc.int/files/4413/5333/7922/Memorandum_of_Understaning_in_Cooperation_in_Taxation__Related_Matters.pdf> accessed 16 May 2015.

144 ibid.

145 SADC, 'Towards a Common Future' (2017) <http://www.sadc.int/themes/economic-development/investment/tax-coordination/> accessed 21 September 2016.

also agreed to ensure information is widely available on the SADC Database and Information Portal[146] in order to avoid unintentional tax inequities.[147]

Challenges that Tax Coordination in Regional Agreements may present

It is acknowledged that tax coordination has proven difficult in practice in many regional groupings. Negotiating and implementing an agreement on tax coordination takes a lot of effort and time, and requires an effective supranational monitoring framework as well as strong powerful institutions to enforce it—a matter that is lacking in many African regional groupings.

Since the international race to the bottom results from granting unstrategic domestic tax incentives, to ensure effective regional tax coordination, the G20 Development Working Group recommends that countries could first start with modest forms of coordination; for instance, by learning from each other on best national policies for distinguishing been strategic and unstrategic tax incentives; and by agreeing on a common framework for reporting tax incentives and information exchange to encourage mutual learning. This could enhance transparency and governance practices, and enable future assessment of tax incentives.[148]

Where regional tax coordination is limited in scope and scale, it may induce tax competition in other respects.[149] Tax coordination among countries in a region can intensify tax competition with outsiders who become the beneficiaries. If coordination is too limited in regional scope, the tax base of the participating countries can become more vulnerable to pressures from outside jurisdictions with lower taxes.[150]

It also needs to be recognised that harmonisation of tax and investment incentives is not a panacea and that other conditions, such as adequate infrastructure and good business climate, must be in place to promote strong investment and economic growth. [151]

CONCLUSIONS AND RECOMMENDATIONS

Although the granting of local tax incentives is often a matter of political decision due each country's sovereign right to determine its fiscal policy, it is important that fiscal policy in Africa does not promote unstrategic tax incentives that result in own tax base erosion. There is considerable scope at the domestic level to improve the effectiveness and efficiency of

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146 SADC, 'Database' (2017) <http://www.sadc.int/information-services/tax-database/> accessed 8 March 2017.

147 SADC (n 146).

148 The G20 Development Working Group (n 2) 32.

149 ibid 30.

150 Michael Keen, 'Preferential Regimes Can Make Tax Competition Less Harmful' (2002) 54 National Tax Journal 757–762.

151 IMF (n 72) para 38.

tax incentives**,** to improve the design of tax incentives, and to strengthen their governance. There is need to undertake more systematic evaluations of tax incentives by carrying out an analysis of the costs and benefits of tax incentives and to publish an annual tax expenditure review of tax incentives as part of the budgetary process. [152]

At the international level, granting tax incentives can result in a race to the bottom, which can be curtailed if countries coordinate their tax incentive policies regionally, so as to mitigate the negative spill-overs from tax competition. Africa's relatively low intra-regional trade integration remains an important obstacle to faster growth. Therefore, regional bodies need to make sure that the potential benefits of a closer regional integration are not undermined by lack of cooperation on tax incentive policies.[153]

[152] The G20 Development Working Group (n 2) 33.
[153] IMF (n 72) para 6.