Perspectives from ATI partner countries on the design of tax incentive regimes

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List of acronyms

ATI	Addis Tax Initiative
CEA	Customs and Excise Act (Malawi)
CSO	Civil society organisation
DRM	Domestic revenue mobilisation
FDI	Foreign direct investment
GDP	Gross domestic product
GIPC	Ghana Investment Promotion Centre
GRA	Ghana Revenue Authority
HDI	Human Development Index
IMF	International Monetary Fund
IPA	Investment promotion agencies
ITC	International Tax Compact
MRA	Malawi Revenue Authority
UNCTAD	United Nations Conference on Trade and Development
VAT	Value added tax
VAT Act	Value Added Tax Act (Malawi)

Executive summary

This brief on the design of tax incentive regimes in ATI partner countries outlines the tax incentive design process and related challenges in Ghana, Malawi and the Philippines. It is based on a questionnaire and interviews conducted with representatives from the respective ministries of finance.

Clear objectives and defined eligibility criteria for tax incentives, as well as the inclusion of the public in the design process, were identified as commonalities between the three jurisdictions. A common challenge faced by all countries interviewed is the availability and collection of data both for cost-benefit analyses and for monitoring and evaluation purposes. Based on existing processes and challenges, these commonalities can be used as a basis for increased collaboration between partner countries in the area of tax incentives in order to improve their design process and effectiveness.

Introduction

Over the past two decades, governments have liberalised laws and regulations governing the establishment of foreign investment projects to attract foreign direct investment (FDI) into their countries. They have granted avenues for free repatriation of investment and profits, generally creating an environment that promotes investment. One key aspect of these promotional efforts is the granting of tax incentives[i].

Most countries grant – in some form or the other – tax incentives with the aim of increasing investment. Partner countries in particular struggle to raise sufficient capital for investing in critical sectors, such as agriculture, extractives and, most recently, information technology. Since tax incentives do not require a direct investment and are *paid* for by forgone revenue, partner countries resort to using tax incentives as one strategy to attract capital to these sectors[ii]. There are options for low-income countries to effectively and efficiently use tax incentives for investment[1]. However, available evidence on tax incentives in partner countries, suggests that they are often ineffective due to weaknesses in design, opacity and administrative challenges[iii]. This leads to further challenges such as economic distortions, corruption and a high opportunity cost of foregone revenue.

The purpose of this brief is to provide examples of the tax incentive design process in three ATI partner countries, highlighting the key similarities and differences. By presenting concrete case studies of Ghana, Malawi and the Philippines, this publication provides insights on the successes and challenges of tax incentive regimes in ATI partner countries. The tax incentives design process is assessed against the following clear design features: clear goals, clear eligibility criteria, clear choice of tax instrument[2], cost-benefit analysis, transparency, consistent monitoring and evaluation, no discretionary powers during the process of granting

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[1] As described by the Platform for Collaboration on Tax (PCT) in its toolkit *"Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment"*, which was published in 2015.

[2] For instance, corporate income tax (CIT), value-added tax (VAT)

incentives, public participation, and parliamentary approval of the incentive. The information in this brief is based on questionnaires and interviews conducted with representatives from the ministries of finance of the respective partner countries.

The tax incentive system in Ghana

Key figures

Population: 29.7 Mil.[iv]

GDP per capita: $2,202[v]

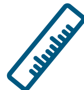
HDI: 0.596[vi]

Design of tax incentives

The main aim of the Ghanaian government when granting tax incentives is to support selected industries, attract investments, encourage savings and promote employment in the country[vii].

Key design features

clear goals



measurable

public participation

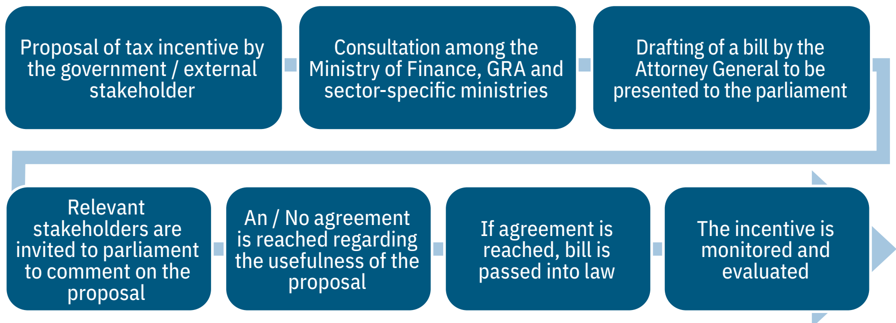
no discretionary powers

Legal framework

The Ministry of Finance is primarily responsible for formulating tax incentives in Ghana. The provisions of tax incentives are codified in the tax legislation and amendments can be made through subsidiary legislation. Tax incentives may also be granted through agreements that are ratified by the parliament and that are not necessarily incorporated in the tax code.

Design process

As visualised in the following graphic, the process undergone in Ghana from the proposal of a tax incentive until its passing or rejection is divided into several steps:



To illustrate the tax incentive design process, the creation of a value added tax (VAT) exemption for imported active ingredients for manufacturers of pharmaceutical products will be used. The tax incentive was proposed by the pharmaceutical industry of Ghana and, according to the Ministry of Finance official interviewed for this brief, it aimed to boost local production and reduce the cost of basic drugs such as paracetamol, cough syrup and hydrogen peroxide. The design of the tax incentive followed a seven-stage process:

Step 1	The tax incentive (VAT exemption for imported active ingredients for manufacturers of pharmaceutical products) was proposed by the pharmaceutical industry.
Step 2	A consultation was carried out after the idea of the tax incentive was developed. Meetings and discussions were held with the Ghana Ministry of Finance, the Ghana Revenue Authority (GRA) and the Ministry of Health. After these meetings, the involved stakeholders presented an agreed list of drugs covered, the descriptions and processes for granting of the incentive, and the intended beneficiaries. This resulted in a final agreement between the Government of Ghana and the industry on the necessity of the tax incentive.
Step 3	The Attorney General drafted a bill based on the previous consultations, which was sent to the Ghanaian parliament for consideration to pass it into law through subsidiary legislation.
Step 4	The Ghanaian parliament invited the public to comment on the proposal, which was open to civil society organisations (CSOs) and other relevant stakeholders, including the pharmaceutical industry.
Step 5	The bill was discussed at the Ghanaian parliament and an agreement was reached regarding the usefulness of the proposal.
Step 6	The bill was passed into law and implementation followed.
Step 7	An evaluation of the tax incentive took place to ascertain if it fulfils its objectives.

Source: Interview with an official from the Ghana Ministry of Finance on 23 September 2019.

Monitoring and evaluation

In Ghana, tax incentive monitoring occurs through inspection visits. Evaluations are made based on the objectives of the incentives. However, there is no single responsible agency and inspections are carried out by the Ministry of Finance, the GRA or other relevant sector ministries. Beneficiaries of tax incentives are required to file tax returns and there are general processes in place to audit the compliance of beneficiaries with respect to the terms and conditions of the incentives. When appropriate and depending on the scale of non-compliance, incentives may be revoked[viii]. According to evaluations carried out, for instance, the tax incentive for the pharmaceutical industry outlined above has been successful. At the point of the interview, the Ghanaian government was discussing the continuation of the incentive to increase the local production of medication[ix].

Challenges

The main challenge in Ghana when deciding on the right tax incentives is the lack of data to analyse and decide which sectors are of priority. The lack of skilled personnel also makes it difficult to monitor all incentives properly. The most common abuses of tax incentive regimes by beneficiaries include the extension of incentives to third parties, application to other purposes, transfer to related parties, and extension to transactions not covered by the incentive[x].

Reform efforts

The Ministry of Finance and the GRA are the main agencies responsible for carrying out tax incentive reforms. There have been reviews in the country that have led to the repeal of some incentives.

For instance, the incentives granted by the Ghana Investment Promotion Centre to existing enterprises under L.I. 1817[3] have been repealed. The

[3] L.I. 1817 was an act first introduced in 2005 to promote tourism by granting duty exemptions, tax holidays and exemption from the payment of VAT and other related charges (GIPC Ghana, n.d.).

L.I. granted incentives to enterprises that were already paying taxes. The tax incentives were not discussed with the GRA and the L.I. changed the provisions in the parent legislation, which was outside the scope of authority, causing their repeal[xi].

In another example, the Minister of Trade set income tax rates for free-zone enterprises and the Free Zones Board at the time claimed it had the authority to do so based on the Free Zone Act. This tax incentive was also removed because due process was not followed, and the act was not backed by law. Currently, the Ministry of Finance is working on phasing out some income tax exemptions, particularly the ones in international agreements without a basis in legislation[xii].

The Ministry of Finance worked on an exemptions act that has been presented to Parliament[xiii]. Among other things, the exemptions act was supposed to streamline tax exemptions, have all the guiding principles and provide provisions to prevent abuse. To date, however, the bill has not been passed into law yet[xiv].

The tax incentive system in Malawi

Key figures

Population: 18.1 Mil.[xv]

GDP per capita: $381.26[xvi]

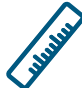
HDI: 0.485[xvii]

Design of tax incentives

Malawi grants tax incentives to attract investments in particular sectors of the economy, ultimately promoting value addition and growth of the economy as a whole. This includes encouraging investment in electricity generation and transmission, agro-processing, and the promotion of domestic production of goods for exports to reduce trade deficits[xviii].

Key design features

clear goals



measurable

public participation

no discretionary powers

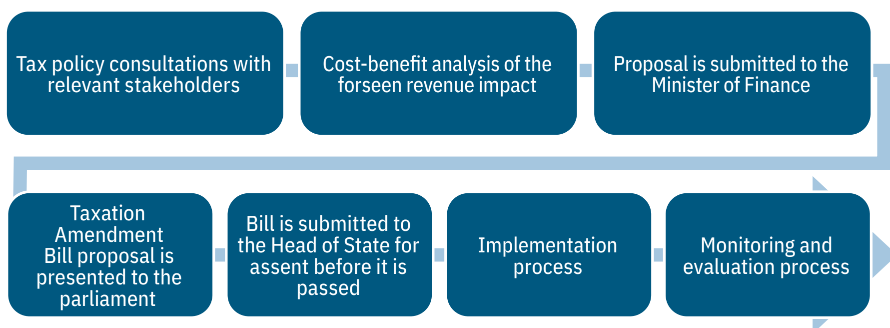
Legal framework

Malawi operates a territorial tax system and taxes are governed by the Taxation Act[xix], Value Added Tax Act (VAT Act) and the Customs and Excise Act (CEA). The Malawi Revenue Authority (MRA) is the agency responsible for the collection of taxes and largely responsible for the administration of tax incentives in the country. Malawi's corporate income tax rate is 30 per cent[xx]. However, if a company is not incorporated in Malawi, an additional tax of 5 per cent applies. The VAT rate lies at 16.5%[xxi]. Tax incentives are contained in the main tax legislation, which includes the *Taxation Act, CEA, VAT Act and the Export Processing Zone Act*[xxii].

The tax incentives in Malawi are codified in the tax law and Export Processing Zone Act. The primary responsibility for formulating tax incentives lies with the Ministry of Finance while the MRA administers the tax incentives[xxiii].

Design process

As visualised in the following graphic, the process undergone in Malawi from the proposal of a tax incentive until its passing or rejection is divided into several steps:



To illustrate the tax incentive design process, the waiver on import duties and import VAT on big buses will be used. The tax incentive was designed to improve investment in the public passenger transportation sector in Malawi. It allowed for the import of new buses or buses used for a period that does not exceed five years without paying import duty, import excise and import VAT[xxiv]. The design of the tax incentive followed a six-stage process:

Step 1	Tax policy consultation meetings with various stakeholders in Malawi were conducted to discuss the proposed waiver on import duties and import VAT on big buses. These stakeholders included the Ministry of Finance, the MRA, bus companies and the public. The interactions and exchanges during this process led to the development of the proposal.
Step 2	A cost-benefit analysis of the revenue impact of the proposal was carried out in line with the Malawi Growth and Development Strategy, the five-year development strategy of the Government of Malawi.
Step 3	The proposal was adopted at the first phase and submitted to the Minister of Finance for consideration.
Step 4	The Minister of Finance prepared a Taxation Amendment Bill and presented it to the National Assembly (parliament).
Step 5	The Taxation Amendment Bill was submitted to Head of State for assent before becoming part of the law.
Step 6	The implementation of the tax incentive followed, with subsequent monitoring and evaluation ongoing as implementation continues.

Source: Interview with an official from the Malawi Ministry of Finance on 6 August 2019.

Monitoring and evaluation

The Malawi Revenue Authority, as part of its routine work, checks and monitors beneficiaries of tax incentives. One monitoring and evaluation exercise has been conducted for priority industry investors (especially in agro-processing sector). Beneficiaries of tax incentives are required to file returns and are subject to general compliance audits.

A review of tax incentives is carried out annually as part of the budget process and includes an assessment of whether the objectives have been achieved or not. The findings may result in the withdrawal of incentives if they have achieved their objectives, or in the adjustment of their conditions if the objectives have not been achieved[xxv].

The waiver on customs duties and import VAT on big buses in Malawi was granted for two years. The main findings of basic assessments carried out by the MRA was that the tax incentive led to a proliferation of big buses and a reduction in transport fares in real terms. According to the Ministry of Finance, the tax incentive achieved its intended objective, leading to the liberalisation of the public passenger transport from government-owned parastatal to the private sector[xxvi].

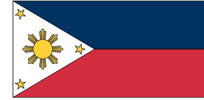
Challenges

According to the Ministry of Finance of Malawi, the main challenge in designing effective tax incentive regimes is a lack of data to objectively assess the incentives' costs and benefits. Tax incentives are difficult to monitor and evaluate due to shortage of skilled personnel. Furthermore, it is often difficult to decide which tax incentive to give or to focus on due to overlapping incentives, which makes it difficult to identify which ones are attractive and minimise revenue loss for the government. Common abuses of tax incentives are not very different from common tax abuses. For example, taxpayers can inflate quantities of materials used in a construction project and, because of lack of capacity of the tax administration, it is difficult to dispute these claims[xxvii].

Reform efforts

The Ministry of Finance of Malawi is responsible for carrying out tax reforms. It is difficult to make changes to tax incentives once introduced, since they become part of the tax system and a long process is required to amend them. However, some incentives have been repealed because they did not meet their set objectives. Tax incentives reforms are considered successful if they account for political support, a strong monitoring and evaluation framework, and supportive legislation in terms of non-compliance penalties[xxviii] in order to meet set objectives.

The tax incentive system in the Philippines



Key figures

Population: 106.6 Mil.[xxix]

GDP per capita: $3,252[xxx]

HDI: 0.712[xxxi]

Design of tax incentives

In the Philippines, the rationale behind tax incentives is mainly to induce FDI, to account for social considerations (such as VAT exemption for senior citizens), and to promote a certain sector or activity.

Key design features

clear goals

measurable

public participation

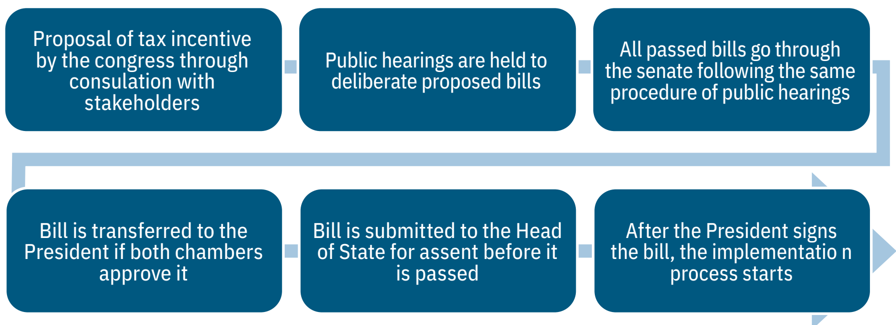
no discretionary powers

Legal framework

In the Philippines, tax incentives are primarily domiciled in the tax law. However, in some cases, they are domiciled in what is referred to as "special laws", which include the charters of the different investment promotion agencies[xxxii]. Tax policy proposals or amendments emanate from either congress or the executive branch of the government with approval by the congress. This also applies to tax incentives that require public hearings with various stakeholders to give comments and exert their position regarding the proposed bill. While the Ministry of Finance also has to approve the bill, he or she plays a minor role in the administrative process. Currently, investment promotion agencies (IPAs) are primarily responsible for designing tax incentives regimes[xxxiii].

Design process

As visualised in the following graphic, the process undergone in the Philippines from the proposal of a tax incentive until its passing or rejection is divided into several steps:



More precisely, the design of the tax incentive follows a five-stage process:

Step 1	In a first step, the Congress of the Philippines comes up with a proposal by filing a bill that will be sent for analysis and comments to different stakeholders, including the Ministry of Finance. While a bill can originate from the executive branch, all incentives must pass through the congress.
Step 2	After the bill is introduced, the Congress of the Philippines deliberates on the bill by holding public hearings, in which all invited stakeholders are allowed to give their comments.
Step 3	After the bill passes the congressional debate and is approved by the committee, it is passed to the Senate of the Philippines, which follows the same procedure of public hearings and approval by the committee. If any differences emerge, a resolution is made through discussions between the senators and congressmen in the bicameral conference. This may involve the Ministry of Finance.
Step 4	The bill is transferred to the President once approved by both Chambers.
Step 5	The President signs the bill into law and implementation follows.

Source: Interview with an official from the Philippines Ministry of Finance on 8 July 2019.

Monitoring and evaluation

The IPAs are responsible for monitoring tax incentives to ensure that their goals are met. Ideally, this should be done through routine compliance checks and audits, as applicable to other taxpayers. Penalties apply if beneficiaries of tax incentives do not fulfil their obligations, such as the cancellation of the registration for the incentive. However, since no monitoring has been carried out yet, there is inadequate information for public discussions on the effectiveness of the incentives[xxxiv]. According to the Ministry of Finance, consistent evaluations have not been conducted at this point.

Challenges

General challenges regarding the design and administration of tax incentives in the Philippines include the difficulty in monitoring firms that are engaged in activities under multiple tax regimes. Additionally, the Philippines has several vertical eco-zones that fall under several different tax regimes, making them prone to abuse. The presence of multiple regimes can create opportunities for abuse, which includes the diversion of activities outside the incentive-designated zones by beneficiary enterprises, non-qualifying activities being included in the incentive's regime, existing firms transforming into new entities to qualify for incentives, and the deferral of deductions at the end of the tax holiday period[xxxv].

Reform efforts

The Ministry of Finance is responsible for tax incentive reforms. In an attempt to review the incentive regime, a study was conducted on the effectiveness of tax incentives in the country. The results of the study showed that resource-seeking firms[4] were granted redundant tax incentives and incentives that did not meet their set objectives, while efficiency-seeking[5] firms were granted effective incentives that met their set objectives. The Ministry of Finance received technical assistance from the International Monetary Fund (IMF) to carry out reforms.

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[4] A strategy in which the main aim of the company is that of acquiring in foreign markets particular types of resources that are not available in the home country, or that are available abroad at a lower cost (IGI Global, n.d.).

[5] Firms coming into a country seeking to benefit from factors that enable it to compete in international markets (Fruman C., 2016).

Conclusion

As outlined in this brief, designing tax incentive regimes is a multi-step process involving various stakeholders from the government as well as civil society and other stakeholders. The process must be tailored to take country-specific conditions into account, including the legal and regulatory frameworks, which differ in each jurisdiction. Irrespective of this, there are certain commonalities between the different processes. The following features have been identified in the jurisdictions of this brief (Ghana, Malawi, the Philippines):

1. The incentives have clear objectives and defined eligibility criteria.
2. The public is consulted in the design of new tax incentives. Generally, there are no discretionary powers in the granting of tax incentives in the three jurisdictions. All tax incentives have to follow a specific process that involves both the public and the parliament.

At the same time, the process of monitoring and evaluating tax incentives differs considerably in these three case studies. There should be formalised procedures and guidance on how to audit tax incentives for beneficiaries to ensure they comply with their terms and conditions. Consequently, there should be penalties in place for beneficiaries that do not comply with the terms and conditions of the tax incentives granted. Penalties such as cancellation and revoking of incentives granted should be considered. Additionally, the effectiveness of each incentive should be systematically monitored and evaluated, with agreed timeframes, to ensure that the intended goals are achieved and the incentives are beneficial for the economy. Consideration should also be given to reporting to Parliament on an annual review of all tax incentives. This is currently not the case in all the discussed jurisdictions. Good practice in the implementation of tax incentives also includes consideration of a sunset clause, i.e. a date by which the incentive will cease to exist, unless a positive decision is made by Parliament to extend the relief.

One common challenge that countries encounter is a lack of available data, which hinders not only the monitoring and evaluation processes but also cost-benefit analyses, which should be carried out prior to the implementation of a new policy. This makes South-South cooperation particularly relevant, since countries who have overcome challenges in a similar context are best suited to help each other find sustainable solutions.

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