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Benefits for whom? Tax incentives in Latin America and the Caribbean

Background

The aim of this paper is to bring together the work done by Christian Aid and our local partner organisations in Latin America and the Caribbean (LAC) on tax incentives, and also to present some key findings as a basis for ongoing advocacy in this area.

The focus on tax incentives grew last year following the global agreement on the Sustainable Development Goals (SDGs). These goals could transform the lives of people living in poverty, but achieving them will cost an estimated $2.5tn each year until 2030.[1]

In order to raise the necessary funds, some commentators are calling for greater private sector investment in SDG-related areas, and for developing countries to seek twice the current growth rate of private investment. In light of this, developing countries face increasing pressure to 'compete' for foreign investment that drives economic growth, and so continue to offer generous tax breaks – known as 'tax incentives' – to corporations.

While tax incentives can be a legitimate tool for governments seeking to attract investment, they can also seriously undermine developing countries' ability to raise revenue to pay for vital development work and key public services, while doing little to increase the quantity or quality of investment.

Christian Aid and our partners in LAC believe now is the time to rethink such harmful approaches.

In this paper, we highlight some instances where offering tax breaks in LAC countries has been damaging, by looking at sectors where tax breaks are particularly prevalent, and we also cite examples of local partners taking action against this. We conclude by suggesting some key principles that we believe governments should adhere to when offering incentives, in order to be fair, transparent and accountable.

An acute need for fair fiscal policies

LAC is one of the most unequal regions in the world. We believe that fiscal policy should be used to tackle the extreme inequality and poverty that exist there, and also to challenge the oligarchic political and economic structures that created this imbalance in the first place. Such fiscal policies should be used to ensure that those who have more contribute more, and that tax revenue is collected to allow governments to ensure provision of key services to all citizens.

Tax structures across the region are generally regressive – more than half of all tax revenue relies on indirect taxes (such as value added tax on goods and services), while direct taxes are collected mostly on labour income rather than on wealth. Many countries do not tax property, capital gains or dividends. This means that the poorest pay the highest proportion of tax, leaving large concentrations of wealth mostly untaxed.

There are also high levels of tax evasion and avoidance. Estimates suggest that, on average, across LAC, 27% of VAT and 46% of corporate income tax was evaded in 2010.[2] The United Nations Economic Commission for Latin America and the Caribbean (ECLAC) sums up the situation, noting that the tax paid by the region's richest is very low 'as a result of evasion, avoidance, exemptions and deductions, as well as the preferential treatment of capital income'.[3]

Tax incentives – that is, deductions, exclusions or exemptions from tax liability offered to entice investors – are a key part of this. A common mechanism used by governments in the region since the 1980s, ostensibly to attract foreign investment, incentives can be a legitimate way to stimulate certain economic sectors. But if poorly planned or granted as part of opaque or corrupt agreements, they can exacerbate poverty and inequality by adding to the burden of the poorest taxpayers, depleting government budgets and creating unfair market competition.

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Tax incentives rarely fulfil their goal

Action Aid estimates that the annual corporate income tax foregone as a result of tax incentives in LAC is likely to run at $33.2bn a year.[4] To justify such costs, there should be clear evidence that tax incentives bring significant benefits, yet this is often lacking.

Probably the most common argument put forward in support of tax incentives is that they attract more Foreign Direct Investment (FDI).[5]

However, a regional study by ECLAC found that fiscal incentives play only a secondary role in a company's decision to invest in a particular country,[6] while an Inter-American Development Bank study found that domestic tax policy, including incentives in Colombia, has had little effect on stimulating FDI.[7]

What seems far more crucial for attracting FDI are business-enabling factors such as: a skilled workforce, infrastructure, economic and political stability, legal certainty, security and market access.[8]

However, governments seem to be stuck in a Catch-22 situation – trying to use incentives to attract investment, but in doing so, eroding their tax revenue and reducing their ability to create conditions that will genuinely increase the prospects of encouraging useful FDI.

It's often argued that such incentives are required to make a country 'competitive', in terms of attracting companies and investment. The reality, however, is often a 'race to the bottom', in which all countries end up losing out.[9] This has been seen particularly in the Caribbean and in Central America. The same problem can exist within federal countries such as Brazil, where state authorities end up competing to provide incentives.[10] Furthermore, when incentives are granted to foreign multinational companies, this can also skew the playing field for local competitors, who lack access to the same favourable terms.

In LAC, many governments have established Special Economic Zones (SEZs) or Export Processing Zones (EPZs) within which companies are offered particular packages of tax incentives more favourable than those given to companies outside the zones. A key benefit of the zones is that they are supposed to help create new jobs, but there are concerns about the quality of jobs created and the violation of workers' rights.

In many parts of Central America and the Caribbean, where these zones are prevalent, the quality of jobs is poor, with many people denied basic labour rights and employed in low paid, non-unionised and precarious work. The labour force is often made up largely of women, who receive meagre wages and suffer high levels of discrimination and abuse.[11]

Elsewhere, much publicised projects fail to live up to expectations, yet investors continue to enjoy tax breaks. For example, the Caracol Industrial Park in Haiti has so far created only 4,500 low-paid jobs, expected to increase to 6,800 by 2018 – a long way off the 65,000 jobs initially promised by 2020. Moreover, more than 1,000 farmers were displaced to make space for the project and lost their livelihoods as a result.[12]

Another argument in favour of tax incentives is that they can attract foreign investors who then introduce skills, technology and knowledge to the local workforce, while forging links with local businesses. However, an ECLAC study found that 'a foreign company may end up as an enclave within the country, and no more than a fraction of the potential benefits will be transferred to the local economy'.[13]

Extractive industries in LAC have seen exponential growth and it is sometimes claimed that incentives are required to bring the level of investment needed to exploit natural resources fully. But while more investment may be necessary, it is not usually driven by the existence of incentives, but by the mere availability of mineral or hydrocarbon deposits and the cost of extraction.

Mining industries are capital intensive, create few jobs locally and tend not to stimulate growth of the local economy. They also create many social and environmental problems, including conflict within local communities, displacement, lost livelihoods and contamination of natural resources. In fact, substantial government revenue is often necessary to offset the negative impact of the industry.

If the governments of countries hosting foreign mining companies renounce the main benefit that they bring to the economy – ie, tax revenue – then it's understandable why grassroots organisations in the region increasingly challenge such projects.

A role for civil society: our partners' work on tax incentives

Christian Aid's partners in LAC are already questioning some of the supposed benefits of tax incentives, while highlighting problems associated with them.

Advocating against harmful incentives

Guatemala has one of the lowest tax revenue rates, not just in the region, but globally.[14] This severely constrains the Guatemalan government's delivery of essential public goods and services. In this context, the Guatemalan government can ill afford to grant unnecessary tax breaks.

Guatemala had to amend its national legislation regarding EPZs by 2015 to comply with World Trade Organization regulations, which considered the exemptions on exports from within the zones as a subsidy and therefore a contravention of free market rules. The Ministry of Economy presented an Investment and Employment Promotion Bill, in January 2013. But rather than eliminating income tax exemptions for companies operating in EPZs, the bill instead proposed to level the playing field by extending these exemptions to other sectors operating outside the zones, for periods potentially in excess of 65 years. This could have resulted in an estimated tax loss to the state of millions of dollars.

Our Guatemalan partner ICEFI launched an advocacy campaign that prevented this bill from being enacted at this time. ICEFI was successful because it presented a technical analysis of the proposal and its potential costs, and enlisted the support of politicians as well as representatives of the business community. Its work demystified the proposal by translating complex technical detail into readily accessible information and involving different sectors of civil society in the debate, warning that local governments and the public education and judicial systems would be directly affected if the bill were passed.

Additionally, ICEFI found new allies, including the Guatemalan Chamber of Commerce – a former opponent of progressive tax reform – women's organisations, churches, indigenous authorities and municipalities. The Chamber of Commerce publicly announced its opposition to the bill, and collaborated with ICEFI and a group of pro-business analysts to warn about the harmful effects of the proposed tax exemptions.

As a result of this increased public scrutiny, the bill was withdrawn in August 2014. More recently, in early 2016, due to a change in the political context following presidential elections in 2015, a modified version of this bill was passed. While this version allows incentives to the export industry and call centres for a further decade, it omitted some of the benefits for all sectors initially proposed. ICEFI continues to advocate on this issue and to challenge the perception held by government officials and politicians that Guatemalan civil society lacks capacity to develop strong technical proposals and engage in effective advocacy and public campaigning.

Quantifying the costs

At the end of 2012, the Colombian government reformed its tax system, promising simplicity, fairness and more jobs. However, a study conducted in 2013 by experts from Red de Justicia Tributaria (Colombian Tax Justice Network), a network set up by Christian Aid partner Cedetrabajo, evaluated the impact of such reform and found that it had failed on all three promises.

The tax system in Colombia continues to be highly regressive: relying heavily on indirect tax, plus an increased income tax burden for the middle class. At the same time, large companies and the richest individuals enjoy a reduction in corporation and income tax rates. By sector, the main beneficiaries of income incentives on tax are finance, services and mining.

As a result of this ill-conceived reform, tax authorities raised 3.3bn pesos fewer than expected ($400m) in the first half of 2013, which could have covered shortfalls in key public services for children and education.[15]

Popularising a complex matter

FIFA's Foul Play (*Las Jugadas de la FIFA*) was a tax campaign led by InspirAction (Christian Aid in Spain) in conjunction with Christian Aid and partners from across the LAC region. The 2014 World Cup provided an opportunity to campaign on the extensive tax exemptions imposed on Brazil by FIFA and its sponsors as part of FIFA's conditions for countries hosting a world cup. The exemptions were estimated by the Brazilian Public Accounts Tribunal to be about £228m ($296m). A sum that Brazil, an extremely unequal country and with high levels of poverty, cannot afford to grant, especially as the total bill of the sporting event came to a massive £7bn ($909bn), half of which was footed by Brazilian federal, state and local authorities.[16]

The campaign gained public support, thanks to existing discontent for the enormous financial and social cost of the event, as well as the accessible way in which the campaign exposed links between tax incentives, poverty and inequality. Securing coverage of the campaign in Spanish, Latin American and British media also helped raise awareness of a little-known issue.[17]

Analysing the impact of SEZs

The Dominican Republic has seen huge growth in SEZs since the 1990s. According to the Dominican Association of Free Zones, in 2012 there were 53 zones employing almost 135,000 people and exporting goods worth nearly $5bn. The main investors and importers of these products are US companies.[18]

Businesses in these zones enjoy a virtually tax-free status, benefit from less red tape and are allowed to set salaries below the national minimum wage. They also have few links to rest of the Dominican economy.

Christian Aid partner Centro Bonó has been analysing the role of SEZs in the national economy in order to advocate for a fairer tax system and ensure that foreign investment brings tangible benefits for the population. They found that incentives offered to companies in the SEZs run into RD$23.451m (approximately $500m) or 0.9% of GDP – a huge cost for the economy of this small country.

Highlighting missed opportunities for taxing extractives

INESC, another Christian Aid partner in Brazil, is calling for proper taxation of the extractive industries, which it argues is essential both to address inequality and to ensure that Brazil's finite resources benefit the public before they are exhausted.[19] Mineral extraction grew 500% between 2000 and 2010. INESC points out that even though Brazilian taxes are complex and numerous, in reality, mining companies do not pay their fair share of taxes due to poor tax design (eg, royalties are paid on net value, which is easy to downplay), lax monitoring, and the prevalence of a series of other practices that reduce tax payments significantly (including trade mispricing).[20]

In addition, mining companies (and other exporting industries) enjoy tax incentives introduced in 1996 with the Kandir Law. This law exempts all products and services for export from value added tax that would normally be excised at state level, depriving local authorities of significant income.

While this approach may have worked 20 years ago when exports were low and the national currency overvalued, it no longer makes sense at a time when Brazil is a major exporter of natural resources. Yet attempts to reform the law in parliament have been repeatedly blocked by powerful lobbies.

Given the social and environmental impact of large-scale mining, as well as the finite nature of the country's natural resources, Brazil's decision-makers face an urgent duty to tax these activities appropriately, so that the population can reap some of the economic benefits. INESC's work in exposing the tax exemptions and incentives in the mining sector is a necessary tool in advocating for change.[21] Awareness raising will be vital for INESC to garner broad support for long overdue legislative changes.

No incentives for gender equality

No tax – or tax incentive – is ever gender neutral and will have different consequences for men and women, given the existing social and economic inequality between the sexes. However, if used effectively, progressive taxation and well thought out incentives could help tackle inequality and gender imbalance. For example, incentives could be designed to reduce pay gaps and inequality among workers and taxpayers. But instead, we often see incentives leading to more inequality and exploitation, as seen in the case of women workers in SEZs.

Our partner CEDLA has conducted gender analysis on tax and spending policies in Bolivia. It did not identify any incentives supporting businesses willing to help address gender inequality. For example, there are no special tax treatments for those companies with informal workers to help them formalise the status of their employees – and most of these workers tend to be women. Neither are there any incentives to prioritise the employment of those who are most discriminated against and disadvantaged, such as tax breaks offered for companies that offer training or hire more women, younger people or ethnic minorities. Finally, there are no incentives for companies to provide care arrangements such as childcare in the workplace, educational grants, canteens or flexible working. Clearly, employers could be encouraged to introduce such staff benefits by offering them tax breaks as an incentive.

A need for clear analysis and greater transparency: where next?

Tax incentives in LAC have often done little to fulfil promises of investment, growth and jobs. Indeed, their cost regularly outweighs the purported benefits. We believe that civil society has a role to play in exposing and gaining support for tackling these issues. Based on our partners' experience and recommendations, and our own work on incentives, we think that civil society in the LAC region should hold governments to account on their approach to using incentives based on the following principles:

- Governments should only offer tax incentives where they can demonstrate that they form **part of a clear and transparent economic development plan.**
- The process of offering tax incentives must be **fully open and transparent.** There should be **no secret deals** and incentives should be open to all companies on an equal basis.
- Governments must develop **effective and transparent mechanisms for evaluating the costs** (environmental, fiscal, exacerbation of inequalities including gender inequality) **and benefits of incentives** before they are granted.
- Governments should **avoid tax incentives that cannot demonstrate a sufficient positive impact** on employment, production, state revenue, social wellbeing and the environment (this principle has particular relevance to the mining sector).
- **Governments must be able to show that they are coordinating investment attraction strategies with other countries in the region, and internally between federal authorities, to avoid a regional race to the bottom** (not only between states, but also within states).
- Governments must use tax incentives to **promote gender equality and support the most disadvantaged** – for example, incentives for companies to provide care arrangements, educational grants or flexible working, or to prioritise the training or hiring of more women, younger people or ethnic minorities.
- Governments should be able to demonstrate that they are also **looking beyond tax incentives** by addressing other key factors that influence business investment decisions, such as infrastructure or skilled workers.
- Tax incentives granted should be **specific and limited in scope and time, recorded in national budget expenditure, monitored and evaluated against their stated objectives, and withdrawn or revised accordingly.** States should be legally accountable to show that the tax incentives they offer are effective.

We would also stress that global companies with operations in developing countries should ensure that they only seek or accept tax incentives available to competitors on equal terms, approved by legislators and publicly disclosed.

With tax incentives, accountability, transparency and availability of information on tax systems and agreements, both within countries and with multinationals, is key.

Endnotes

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2. Gomez Sabaini, JC, Moran D, *Política Tributaria en América Latina*, published by ECLAC in 2013, p73, available at: http://www19.iadb.org/intal/intalcdi/PE/2013/12391.pdf
3. ECLAC, *Fiscal Panorama of Latin America and the Caribbean 2015*, March 2015, http://repositorio.cepal.org/bitstream/handle/11362/37748/S1500110_en.pdf?sequence=1
4. Action Aid, *Give us a Break: how Big Companies are Getting Tax-free Deals*, June 2013, p8, actionaid.org/sites/files/actionaid/give_us_a_break_-_how_big_companies_are_getting_tax-free_deals_2.pdf
5. FDI is investment from one country into another, usually by businesses rather than governments, and involving the establishment of operations or acquisition of tangible assets, including stakes in other companies.
6. ECLAC, *Foreign Investment in Latin America and the Caribbean*: 2006 report, 2007, cepal.org/en/publications/foreign-investment-latin-america-and-caribbean-2006-report
7. Ibid.
8. Ibid, and IADB, *Corporate Tax Stimulus and Investment in Colombia*, 2010, iadb.org/en/research-and-data/publication-details,3169.html?pub_id=IDB-WP-173
9. In a race to the bottom, countries end up competing with each other to give the highest tax breaks, reducing further any potential income from foreign investment and eroding wages and environmental and human rights standards.
10. In federal systems (such as that of Brazil), local authorities can offer separate incentive packages on their own, resulting in poor coordination with other authorities and even creating competition between various regions in the same country – which is unlikely to benefit its inhabitants. See note 6.
11. Oxfam Intermon, *Derechos que Penden de un Hilo*, April 2015, available at: https://oxfamintermon.s3.amazonaws.com/sites/default/files/documentos/files/DerechoQuePendenDeUnHilo.pdf
12. See Devex's article: *The Twisted Tale of Caracol Housing*, 16 January 2015, devex.com/news/the-twisted-tale-of-caracol-housing-85109 and Action Aid's *Building Back Better? The Caracol Industrial Park and post-earthquake aid to Haiti*, January 2015, actionaid.org/sites/files/actionaid/building_back_better_the_caracol_industrial_park_and_post-earthquake_aid_to_haiti.pdf, huffingtonpost.com/marie-clarke-brill/too-quick-to-dismiss-crit_b_6481932.html
13. See note 6, p88.
14. World Bank, *The Economic DNA of Guatemala*, 2014, bancomundial.org/es/country/guatemala/research
15. Justicia Tributaria, *Balance de la reforma tributaria*, October 2013, http://justiciatributaria.co/blog/2013/10/07/balance-de-la-reforma-tributaria/
16. See 'La FIFA juega sucio en Brasil', http://blogs.elpais.com/3500-millones/2014/06/la-fifa-juega-sucio-en-brasil.html
17. Further information, blogs, audiovisual and social media material are available here: http://www.lasjugadasdelafifa.inspiraction.org/
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20. This article explains the concept of trade mispricing, https://financialtransparency.org/trade-mispricing-an-exercise-in-vastness/
21. Ibid.

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