FEBRUARY 10, 2025

COMMENTS ON DRAFT TAX INCENTIVES PRINCIPLES BY PLATFORM FOR COLLABORATION ON TAX

We appreciate the opportunity to provide feedback to the ***Platform for Collaboration on Tax*** on the document on ***Tax Incentives Principles***. Tax incentives, also known as tax expenditures, play a critical role in domestic resource mobilization and fiscal sustainability. Developing countries, especially those striving to achieve Sustainable Development Goals (SDGs) and manage climate transitions have substantial financing needs. The G20 estimates that an additional $3 trillion per year will be required from 2025 to 2030, to meet development and climate goals, with two-thirds of this amount expected to come from domestic resources. However, many low-income countries have tax-to-GDP ratios below the 15% threshold needed for sustainable development financing. Therefore, codified principles to guide tax incentives are crucial. Beyond fiscal impacts, transparency and accountability in the application of these incentives are essential for achieving efficient outcomes.

Our concerns regarding the principles outlined in the document on tax incentives are as follows.

COVERAGE

The document attempts to address a vast range of tax incentives, including corporate income tax (CIT), personal income tax (PIT), and indirect taxes. Given the distinct nature of these incentives, it would be beneficial to specify principles for non-CIT incentives separately.

Justifying Tax Incentives

The principle of ensuring "net social benefits" as a justification for tax incentives is problematic in practice. The concept is highly subjective and difficult to quantify. Without clear methodologies or examples, calculations can be misleading or unreliable. Governments, particularly in developing countries and investment hubs often lack the expertise and resources to accurately estimate the costs and benefits of incentives in advance.

Employment Generation as a Key Justification

Principle 1.1 does not explicitly refer to employment generation as a reason for granting tax incentives. Given that job creation is a fundamental objective of many incentives, it should be explicitly included.

DESIGN OF INCENTIVES

Targeted Incentives vs. Subsidies

While direct subsidies or cash grants could potentially be more effective than tax incentives in certain scenarios, they are often too costly for developing countries to implement widely, making them impractical. Direct subsidies require immediate public financing, which can strain the limited budgets of these nations. The principles should acknowledge that subsidies such as refundable tax credits distort the investment playing field and privilege countries who have more finances at their disposal to offer these credits and thus attract more investment.

Income-Based vs. Expenditure-Based Incentives

The principles indicate a preference for expenditure-based incentives over income-based ones (e.g., profit-based tax breaks) because expenditure-based incentives tend to encourage immediate investment and economic activity. It should be recognized that many developing countries rely on income-based incentives because they are less costly upfront.

Subsidies vs. Tax Incentives

Tax expenditures (incentives) are essentially a form of subsidy. The long-term impact of these policies on debt sustainability is significant, as demonstrated in the IMF's 2023 Fiscal Monitor. Policies like the U.S. Inflation Reduction Act, heavily reliant on subsidies, have shown adverse impacts on debt sustainability compared to taxation measures. Research also indicates that tax incentives can sometimes lead to a "race to the bottom," where countries continuously lower tax rates to attract investment, ultimately reducing their tax base and fiscal capacity.

Governance and Transparency

Transparency and good governance are critical in the administration of tax incentives. Without proper oversight, there is a risk of corruption and misallocation of resources, which can undermine the intended economic benefits. The document suggests that the Ministry of Finance should oversee tax incentives, but in many countries, the Ministry of Trade or Investment plays a leading role, largely because they administer incentives such as Special Economic Zones, trade related waivers and concessions. Therefore, we call for strong coordination between all relevant agencies, with the Ministry of Finance retaining overall oversight to ensure macroeconomic stability. Without oversight, tax incentives could lead to fiscal mismanagement and loss of macroeconomic control. Moreover, requiring parliamentary approval for tax incentives may slow down implementation significantly and it may not be feasible for governments that need to act quickly on emerging opportunities. It should be enough that incentives are incorporated in annual appropriations that go through the legislative process.

Areas of Further Guidance

There is insufficient clarity on the use of incentives to support net-zero transitions. Principle 1.4 is particularly ambiguous on whether businesses should be incentivized or penalized to achieve environmental goals. Taxing pollution can drive change but often hurts lower-income households who cannot afford renewable energy. A balance between taxes and incentives is needed. Simply taxing polluters raises costs without reducing pollution. Tax incentives, rather than subsidies, could encourage businesses to achieve net-zero emissions.

Capacity development

Overall, there is a need for more practical guidance, clearer definitions, and capacity support to make the principles effective in real-world policy implementation. Effective tax incentive impact assessment requires skilled personnel within tax policy teams and ministries of finance. However, many governments struggle with staffing and technical expertise, making high-level principles challenging to implement.