# Why African Countries need to rethink tax incentives in the post-pandemic Era

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**Introduction**

The COVID-19 pandemic has raised questions on the sustainability of the health system in most African countries. This is largely tied to the poor funding of the health sector which limits the efficiency of the response to pandemics, including a limited capacity to invest in the development of vaccines or establishing fully enough equipped isolation and treatment centres, leading to unnecessary loss of lives and a strain on the countries' budgets. The challenge in funding public health has serious implications for a state-citizen relationship, oftentimes resulting in a poor social contract.

Poor public funding in Africa is strongly linked to weak taxation systems because African countries do not generate enough revenues to fund their annual budgets. There are many reasons why African countries do not raise revenues; however, one that has been often overlooked but is gaining attention recently is tax incentives.

According to IMF et al., Tax incentives have been defined as any special tax provision granted to qualified investment projects or firms that provide a favourable deviation from the general tax code. Tax incentives have been classified along 4 categories. First, tax incentives can be broadly categorised as profit-based or cost-based. Examples of profit-based incentives include tax holidays and tax exemptions or reduction, while cost-based incentives include accelerated depreciation, capital allowance and tax credits. According to studies, Profit based incentives are those incentives that make more profitable investments that would be profitable even without incentives, while cost-based incentives are those that may lead to investments that would not have otherwise been made. Hence, profit-based incentives are regarded as more harmful than cost-based incentives.

Additionally, Tax incentives can be location-specific such as designated areas for economic zones, or non-location specific to apply to a certain sector or throughout the country. Tax incentives can also be granted temporarily for a specified duration or permanent without any time frame. Lastly, tax incentives can be granted with a reduced rate – as a partial exemption or full exemption with zero taxes to be paid.

### What is Africa doing wrong on tax incentives?

African countries continue to grant wasteful and ineffective tax incentives in a bid to attract foreign direct investment (FDI) despite research showing that these incentives are oftentimes costly and do not necessarily lead to additional investment. The opportunity costs of these incentives are not only high but translate to less spending on public health. For example, according to a study, in Nigeria, in five years, two subsidiaries of a group saved over $280 million in taxes due to a tax holiday scheme called Pioneer Status. According to another study, overall, Nigeria loses $2.6 billion annually to tax incentives under pioneer status. These taxes lost through frivolous and ineffective incentives would have been invested in the public health system of African countries instead of leaving citizens in a vulnerable state.

In Africa, despite research showing that profit-based incentives are harmful, African countries continue to grant more of profit-based incentive. The tax incentives are often granted without conducting any cost-benefit analysis and are usually subject to discretion and abuse. Additionally, in many cases, tax incentives do not pass through the necessary scrutiny of the parliament, which means there is little or no public participation. Furthermore, incentives are offered and administered by different agencies, often leading to duplication of duty and lack of coordination.

Another problem with the tax incentives framework is that most African countries do not conduct monitoring and evaluation after granting the incentives, and they do not calculate and publish the cost of incentives otherwise called tax expenditures. This opens up the countries to several risks such as wastage of revenue, corruption and poor budgeting and funding of public goods and services.

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According to investment surveys, tax incentives generally rank low in investment decision making in low-income countries, and in some cases, they can be redundant with no effect on investment decision. This has been proven in a study on profit-based incentives in the form of tax holidays; the study revealed that the effect of tax holidays on foreign direct investment is insignificant and does not lead to real capital formation or economic growth.

Also, the opportunity costs related to tax incentives in African countries can be high, which reduces the capacity to fund public services or social investment. For example, in a study on tax incentives in South Africa, "*overall tax incentives encouraged an additional investment of 2.1 billion rand each year between 2006 and 2012. […] The revenue foregone as a result of the lower tax as a result of the tax incentives is about 4.5 billion rand each year over the seven years. […] In terms of jobs, the tax incentives have resulted in 34,000 additional jobs. However, it has not come cheap, costing an average of about 116,000 rand of revenue foregone for each job in South Africa.*" (World Bank Group, 2016). This has serious implications for funding critical sectors such as health and in meeting standards such as the Abuja declaration - a standard that requires African countries to dedicate at least 15% of annual budgetary allocation to health. Currently, only a few African countries have reached the 15% mark with questions remaining on actual disbursement.

Evidence also suggests that Tax incentives can lead to round-tripping, particularly if incentives are targeted at FDI. Round tripping means money going out of the country and returning disguised as FDI, whereas its origin is local. Tax incentives have the potential to increase the rent of MNEs with no commensurate tax to pay and the risk to exacerbate inequality.

Perhaps one of the most important reasons to rethink tax incentives in Africa is the current work under the Pillar Two of the Unified Approach under the so-called Inclusive Framework on Base Erosion and Profit Shifting (IF-BEPS). Pillar Two proposes a global minimum tax rate to address *the race to the bottom.* The potential implication for this is that if an agreement is reached under the IF-BEPS African countries may lose out on revenues, as tax not collected in African countries may be collected in other countries.

**What steps should be taken post-COVID?**

As evidence shows that tax incentives are not key drivers of investment and the opportunity cost of the incentives are high with dire implications for the health sector in Africa, it becomes pertinent for African countries to re-evaluate and reform their tax incentives frameworks.

To achieve this, African countries need to ensure that all tax incentives are only considered after conducting a cost-benefit analysis of the potential impact of the incentives. If tax incentives are granted, they should be followed with periodic monitoring and evaluation to ensure standards are adhered to and the aims and objectives of the incentives are met.

Furthermore, African countries should focus on cost-based tax incentives which are less harmful than profit-based incentives. To improve the social contract between the state and citizen, transparency of tax incentives is necessary; therefore, information regarding the objectives of the incentives, the beneficiaries as well as the amount of revenue forgone due to the incentives should be made public.

Lastly, incentives, before being granted, should go through the parliamentary process with public participation for the necessary scrutiny and address any abuse that may arise from the use of discretionary powers by the executive.

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