Tax Incentives for Attracting FDI in Sub-Saharan Africa: Comparing Ghana and Kenya

By:

Patrick Ofori

August 26, 2019

Developing countries have increasingly resorted to the use of tax incentives to attract FDI, despite existing evidence of their shortcomings. In sub-Saharan Africa countries (SACs), tax incentives feature prominently in many tax codes and investment laws. Although rates vary widely by jurisdiction, in most cases, taxes remain attractively low, and various tax incentive schemes, including tax holidays, preferential tax rates, manufacturing zones, and concessionary tax arrangements, have been designed to promote investment. Tax incentive packages, in most cases, are further reinforced by bilateral investment treaties or double taxation agreements, restricting SACs’ ability to tax income earned by non-residents.

It seems to me that SACs find tax incentives as a means of attracting FDI because of the emphasis that is laid on the potential of tax incentives as part of general pro-market liberalization measures to attract FDI and stimulate economic growth and development. Further, because most SACs do not have viable alternatives, per se, to raising funds for development, they believe that tax incentives can be structured to ensure that FDI advances socio-economic and technological development.

However, the reliance on tax incentives at the expense of maximizing domestic tax revenue poses a challenge to sustainable development. In most cases, the attention of policy-makers and citizens is not drawn to the potential downside of tax incentives. Tax incentives may appear to be costless, but may entail significant costs. Generally, tax incentives are not well designed and administered. Moreover, even though tax incentives have not brought about the needed investment, and result in unintended consequences, they continue to be offered.

For SACs in particular, there are three main reasons the use of tax incentives to attract FDI may not be the right approach. First, the reliance on tax incentives to attract FDI poses a challenge to sustainable development. By focusing on attracting global capital, the risk of potential revenue loss is often forgotten or underestimated. In addition, tax incentive programmes suffer from weak design, lack of transparency, administrative inefficiencies and inappropriate targeting. Even where tax incentives ought to be aimed at efficiency-seeking FDI, they are generally offered to all investors, including those motivated by access to natural resources or market. Second, tax incentives have inherent costs, which if not well provided for, may outweigh their benefits, and erode the tax base. Tax incentives come with increased administrative and compliance costs, and require extensive tax planning and anti-avoiding strategies, without which they can result in economic distortions, engender corruption, and benefit TNCs and home countries more than host countries. Third, empirical evidence suggests that governments in SACs are paying too much by using tax incentives to attract investment. Tax incentives have not been effective, and their impact has been detrimental – only a small number of them have had marked success, many more have failed and have been abused by both investors and government officials, serving only the interest of a few elite individuals, and making the states and the citizens worse off.

Ghana and Kenya provide useful illustrations of some of the risks of using tax incentives to attract FDI. In Ghana, an analysis of the use of tax incentives between 2008 and 2013 revealed that tax incentives accounted for a loss (tax expenditure) of about 14.18 per cent to 41.20 per cent of total tax revenue, about 1.80 per cent to 5.31 per cent of total GDP. Similarly, in Kenya, tax incentives have been found to deprive the country of revenue needed to improve the general welfare of the population. It is estimated that over USD 1.1 billion is lost annually through the use of tax incentives in Kenya. Additionally, during the fiscal year 2009-10, an estimated amount of USD 3.05 billion, about 3.1 per cent of the GDP, was projected to have been lost through tax incentives. Moreover, the use of tax incentives has resulted in the neglect of other desirable goals associated with taxation, such as simplifying the tax system, strengthening tax administration, and achieving equity in the tax burden.

Therefore, any attempt to consider tax incentives as an economic policy option must be balanced with a due consideration of the potential harmful effects of tax incentives. Tax incentive programmes must be well designed to maximize efficiency and effectiveness. Even where tax incentives clearly play an important role in attracting new investment, the cost at which that may come must be considered, more so, given that most tax incentive schemes are likely to result in small incremental new investment. Furthermore, the inherent costs of tax incentives in terms of the economic distortions that are associated with them, and the opportunity for rent-seeking and corruption that come along with them, must be taken into consideration.

Based the observation from Ghana and Kenya, there is the need to improve the efficiency and effectiveness of investment tax incentives to ensure transparency, accountability, reduce associated costs, and check abuse. Five recommendations are made to enable effective and efficient use of tax incentives. First, tax incentives schemes should be designed to achieve clarity in objective and purpose, and consensus among stakeholders regarding their general fitness for purpose. Second, tax incentives should be targeted at sectors geared toward export and mobile capital, which appear to be relatively effective, and not at sectors producing for domestic markets or extractive industries, which, generally, have little impact. Third, enabling conditions such as, good infrastructure, macroeconomic stability, rule of law, should be enhanced. Fourth, the use of tax incentives must be transparent in order to facilitate accountability, and reduce the potential for rent seeking and corruption. Tax incentives must be subject to parliamentary approval, be consolidated under the tax law, and reviewed annually as part of a tax-expenditure budget. Fifth, the approval process of tax incentives should be consolidated ultimately under the authority of the Minister of Finance and Economic Planning, to be enforced and monitored by the tax authorities. Granting of tax incentives should not be based on discretion, but on the application of rules and procedures.Finally, tax incentives schemes should be simple and uniform, rather than discriminatory.

These issues were considered at length in my LL.M. Thesis at Schulich School of Law, Dalhousie University.

View online: Tax Incentives for Attracting FDI in Sub-Saharan Africa: Comparing Ghana and Kenya