Tax Incentives in Developing Countries in an Era of COVID-19

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Jun 24, 2020

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1. COVID-19 and fiscal policy response

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- **The global impact of the COVID-19 on economic output and public** finances in 2020 and beyond is projected to be massive
- All countries are **deploying fiscal policy to mitigate pandemic's impact** and promote economic recovery
- **The cost of fiscal measures** has ranged between 1 percent and 40 percent of GDP—fiscal packages are larger in advanced economies—the global cost of fiscal measures (including increased allocations for health) implemented so far is $10 trillion

2. Fiscal responses in selected developing countries

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- Fiscal packages in developing countries have included
  - **Reductions in standard VAT rate, personal and corporate income tax, and turnover tax** (Kenya); support to hotels, restaurants, and transport, including suspension of VAT paid by these sectors (Senegal); and **waiver of import duty on medical equipment** (Bangladesh, Nigeria, and Zambia); on the spending side, social assistance has been extended to poor families (in Senegal to one million families)
- **Fiscal packages are smaller**—in sub-Saharan Africa, the highest so far is in Senegal costing 7 percent of GDP
- These measures would reduce revenues in relation to GDP in 2020 and possibly beyond, with important implications for public spending and fiscal deficits

3. Changing landscape facing developing countries

- The crisis is likely to **alter the economic structure** of these countries in a major way (loss of revenues from tourism, commodity exports, remittances)
- Their **debt-to-GDP ratio is likely to rise** going forward because of the crisis response and falling output--this ratio stood at 57 percent in 2019 in sub-Saharan Africa
- **Tax compliance** may weaken
- And finally, the **outlook for aid flows is likely to change** with rising debt-to-GDP ratio in donor economies

4. A reconsideration of revenue raising strategy post COVID

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- **Going forward, countries would have to embrace a comprehensive reform package**, including policies that have encountered political opposition in the past—such as the reform of tax expenditures
- **Include reversal of** poorly targeted tax measures (such as the VAT rate cut and reductions in the top personal tax rate in Kenya)
- To induce taxpayers to take their obligations seriously, **governments would have to spend their limited resources better**
- These steps should **garner popular support** because they would be perceived as fair
- This is necessary because SDG needs are enormous--in five areas (education, health, roads, electricity, water, and sanitation) the requirements are estimated by the IMF at 15 percent of GDP on average in low-income countries

5. Towards a targeted policy response

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The COVID-19 presents an **opportunity to implement reforms opposed by vested interests; they include:**

- ***Announcing scrutiny of all tax concessions and instituting enhanced budget transparency:*** In all countries, favorable tax treatment has eroded the tax base--their origins lie in part in industrial policy, but have morphed into protection for the politically connected
  - **In Senegal, tax expenditures were estimated at 7.8 percent of GDP in 2014**, accounting for 40 percent of tax revenues
  - **In Kenya**, companies often shut down their operations when tax concessions expire and open a new company with a different name in another jurisdiction to avail themselves of tax benefits

5. Towards a targeted policy response

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- **Bangladesh has exempted much of the income emanating from the fast-growing ready-made garment secto**r, and from companies producing power, engaged in electronics and located export processing zones
- In Latin America, tax expenditures average 4 percent of GDP
- The comprehensive revenue strategy must include **public listing of all tax concessions and discussing them in the parliament in the context of the annual budget**; and publishing information on beneficiaries of tax concessions
- Countries taking emergency IMF assistance are committing to a high level of **transparency of public spending** (e.g., undertaking to publish procurement contracts and auditing); they should leverage this requirement to embrace a more comprehensive approach noted earlier

5. Towards a targeted policy response

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- *The **other elements of the targeted policy response** should include:*
- ***Addressing international tax challenges that arise in dealing with multinationals***: Rather than focusing on the minimum standards as stressed under G-20-OECD BEPS Initiative, these countries should:
  - Impose a limit on interest deductions by multinationals as well as impose a withholding tax on payments to non-residents at a rate of 10 to 15 percent, covering dividends, interest, rent, royalties, management fees and technical service fee

5. Towards a targeted policy response

- ***Eliminating temporary tax cuts given under COVID-19*** as they would reduce the effectiveness of the tax system to raise revenues
- ***Enhancing VAT productivity*** *as* improved design and compliance with the VAT law can potentially generate more revenue than other taxes
- ***Strengthening/implementing property taxes***
- ***Adjusting excise taxes on tobacco, alcohol and petroleum***—Taxation of petroleum should reflect the cost of externalities associated with its consumption, including the impact on climate
- **Finally, enhancing spending efficiency** can free up as many resources as through increased mobilization of domestic revenues—social and infrastructure spending are areas where there is scope for efficiency enhancement