Tax Competition:
The role of Tax incentives in encouraging harmful tax competition in the East African Flower industry

Alvin Mosioma
Co-ordinator Tax Justice Network for Africa
Email: africa@taxjustice.net

Introduction

In recent decades, there has been increasing competition among governments to attract foreign direct investment (FDI) by offering a wide range of tax incentives. This so-called tax competition has been driven by several dimensions of the international economy: the increasing mobility of multinational corporations, the simultaneous trend towards trade liberalization, and the elimination of controls of capital flows[1].

The debate on the impact of tax competition particularly in developing countries is not well researched. There exist different opinions among economists not only on these questions but on the role of the FDI which this competition strives to attract – as well as economic growth in general.

This presentation looks at the flower industry in the East African region and how tax competition between the countries in the region has led to a **race at the bottom.**

Faced with the pressures of globalization of capital movement and the threat that companies will relocate unless provided with concessions such as more lax regulations and lower taxes, governments have responded by promoting tax incentives to attract and retain investment capital[2].

Having limited economic options the countries in the region have made tax competition a central part of their development strategy to attract and retain the companies in their countries .

The paper concludes that tax incentives and the ensuing competition have largely benefited foreign multinational at the expense of Government revenue, local authorities, domestic enterprise, Workers, and the environment. They have only managed to attract short-term investments (footloose investments) which build no linkages to domestic economy and encourage exploitive competition.

Flower Sector

International cooperation agencies and institutions like the World Bank have promoted the floriculture industry as a solution for economic crises facing poor developing counties[3]. From Columbia to Ethiopia, from Uganda to Ecuador, we have witnessed a number of developing countries enter into flower export markets and busily implement policies to enhance their competitiveness in order to win a piece of the cake of this lucrative global market estimated to be worth US$250 billion. The East African region has seen Kenya, Uganda, Tanzania and Ethiopia develop this sector and engage in a stiff competition to attract inward investments.[4] Their efforts have often been praised as an economic success, one that has successfully coped with globalization. They have been cited as a good if not perfect example of what good economic policies can do towards achieving economic development. It is argued that the incentives provided by the governments have attracted FDI and directly contributed to the growth of the sector.[5]

The premises underpinning the case for tax incentives in developing countries are first that investment is needed to foster more rapid growth; and second that tax breaks can be effective in stimulating investments

The incentives offered to foreign investment in targeting the flower sector include the following:

- 10 year corporate income tax holidays
- 10 year withholding tax holiday on dividends and other remittances to non-resident parties
- Perpetual exemption from VAT and customs import duty on inputs, capital equipment and other resources
- Perpetual exemption from payment of stamp duty
- Subsidized financing loans

The justification for this tax incentivisation is based on the argument that:

1. Increased government revenue.
2. The inward investments will lead to job creation
3. It will lead to technology/ know-how spill over
4. Facilitate a backward/forward linkage to local economy

A glance at the figures for Kenya indeed seems to support this argument.[6]

- The sector has experienced rapid growth becoming the second highest foreign exchange earner after tourism beating the traditional sector of tea and coffee with earnings growing from US$70 million in 1997 to US$465 million in 2006.
- Kenya is today a global player in the flower export supplying 32% of the European market, with 69% of this being through the Dutch auction. Other destinations include the UK, which accounts for 19%, Germany, which accounts for 6%, and a range of other smaller destinations making up the remainder.
- Companies operating in this sector have been registering continuous profit growth in the last 10 years with the industry maintaining a 20% growth per annum.
- The sector has created estimated 50,000 jobs.

However a closer look into the sector paints a different picture. Although there have been some investments in the sector almost all counts the companies have not delivered on the expected returns. The real winners in this economic success remain the foreign multinationals who are reaping huge tax free profits and literally smiling all the way to the bank. In all the four countries the sector is dominated by a few foreign firms who control the market. In the case of Kenya, the industry is dominated by large scale companies who make up to 70% of total flower exports.[7] The picture is not very different in the other three East African countries. The industry is a good example of the way globalization carries a heavy price tag for poor countries.

This cut-throat tax competition between countries has forced the countries in the region to bend over backwards in terms of the incentives offered to attract inward investment. This has come at the cost of undermining their revenue bases and eroding the tax base with no benefit to anyone other than the multinationals that dominate the market. The flower firms have not hesitated to exploit the situation by demanding more advantages and support from the governments, always backed with threats to relocate to neighboring countries.[8]

The result of the competition has been disastrous in many ways. Today the flower sector in many regions around the world provides a good example of the damage of tax competition. It is often stated that tax competition only leads to a race to the bottom as countries converge in terms of incentives they offer to foreign investors. For the East African region however this is no longer a race to the bottom but a **race at the bottom.**

In this race at the bottom, the above stated justifications for giving tax incentives to companies investing in the flower industry seem hollow, involving dismal benefits:

1) Government revenue;

The subsequent competition to attract or retain flower firms in their countries has led to countries in the region not just reducing the tax levels to zero but additionally offering subsidized financial incentives like loans to already financially well-endowed foreign companies[9]. The governments, practically boxed into a tight corner, either agree to forgo revenue and continue offering further incentives or risk the relocation of the firms to neighboring countries. Although there are no concrete numbers of the amount of revenue losses that governments are incurring through tax incentives, what is clear is that the trade does not make any substantial contribution through taxes. Additionally, a large part of the profit does not stay in the country. The industry is characterized by a high level of leakages. The *Horticultural Crops Development Authority* (HCDA), a Kenyan parastatal established to promote and develop the horticultural industry, has been trying to check the leakage of foreign exchange, but this has proven to be very difficult.[10] A reason for this is that many of the banking transactions take place outside Kenya.

A quote from a union leader describes this situation:

> *We are handicapped in our negotiations for better pay because we have no tangible information about the profits made by the flower firms. The trade is done in Europe, so it's difficult to know the profit margin.*[11]

The local governments: Tax exemptions have not only led to revenue losses for central governments but also strained local governments. The influx of high numbers of people moving from other parts of the country to work in the flower farms The incentives offered to foreign investment in targeting the flower sector include the has severely overstretched the facilities at the local government level. The authorities are not able to provide adequate education, health and housing facilities due to the massive population increase. Attempts to introduce or increase levies are met with stiff resistance from the flower lobbies with threats to relocate. In any case, the local authorities are also bound by laws that protect foreign direct investments from such taxation. The situation results in a contradiction – the flower farms are always complaining of the poor

infrastructure and road systems and calling on the governments to improve this while at the same time threatening to relocate if the local authorities make them pay levies.

2) **Job Creation.**

According to the statistics the flower sectors has created thousands of jobs in the countries of East Africa. However it's important to note that over 75% of the jobs are casual laborers earning on average US$40 per month, which is 33 cents above the one dollar per day poverty level margin. In other words the employment creation has been meager with the workers sustained in perpetual poverty.[12] Of every 100 employees in the flower sector, 70 are casual employees of which 50 are women. With the flower sector being a labor intensive industry, poor countries have marketed themselves as sources of abundant cheap labor. However, in these countries, relying on cheap labor as their comparative advantage has created a situation where workers work under severe exploitive conditions and has led to fierce criticism of industry with many international campaigns to change this.[13] The question must be asked therefore if indeed the benefits of job creation have been achieved or whether the floriculture industry is actually manufacturing poverty and oppression.

2) Technology / Know-how Transfer. There exists hardly any technology transfer from multinationals to small scale growers. On the contrary the technology and information gap between the big multinationals and the small scale growers has heavily contributed to the crowding out of small scale growers from the market. With the introduction of very stringent market regulatory standards many small scale growers have been locked out. Additionally there are hardly any know-how spillovers. Finally, the knowledge generated in this sector is barely linked to national agricultural research in many countries.

3) Forward/Backward Linkages. Investments in the flower sector are footloose investments. The tax incentives have only managed to attract short-term investments that are not rooted in the local economy through supply or demand linkages. Therefore, in several countries the linkages between the cut flower industry and the domestic economy are mainly limited to labor, and could hardly be considered as a new and integral part of the national economy. Additionally, the short term nature

of the investments attracted by these tax incentives has created new venues for exploitation as companies move to new jurisdictions after the expiry of their tax holidays.
Besides failure to deliver tangible results in any of the four justifications for incentivisation the flower industry has been a source of environmental degradation. The environmental exploitation has led to the massive pollution of surrounding waters from toxic chemicals from the farms as well as the depletion of water levels.

Conclusions

It is clear that using tax incentives to attract or retain mobile capital does not provide a sustainable basis for creating jobs or achieving any tangible economic development. The costs of such policies far outweigh the benefits with the major beneficiaries being the multinational companies. The incentives encourage unhealthy competition among states and at the same time create an imbalance between domestic enterprises and MNCs to the advantage of the latter. In the case of flower industry tax incentivisation has led to intense competition and served as a catalyst for exploitative conditions – to the detriment of the exchequer, the local authorities, the workers, domestic enterprise and the environment.

Tax competition on not limited only to the flower sector but is affecting other sector. The establishment of export processing zones (EPZ) is creating enclaves for foreign investor separated for the domestic economy and enjoys special tax rebate that are not given to the rest of the sectors. The effects of such incentivisation policies are in poor developing countries are not well researched and there is need for further researched to evaluate their welfare implications. However it's clear that these policies encourage the exploitation of available resources including raw materials and abundant labor force at the expense of the state and the welfare of its citizens an are an avenue for harmful tax practices by the companies.

Potential solutions to this **race at the bottom** lie for in strengthening regional and multilateral bodies to offer guidance in designing tax policies beneficial to all members and protect them from unregulated pressure from large corporations to provide needless and harmful tax incentives.

References

[1] Tax Justice Network: Closing the Floodgate.
[2] Tax Justice Focus Vol. 2. Nr. 4
[3] Zeng Douglas: Knowledge, Technology and Cluster based growth in Africa. WBI Development Study
[4] The East African . 27th March 2007
[5] Wells, L N .Allen, Jacquis Morisset and Neda Pimia. 2001. Using Tax Incentives to Compete for Foreign Investments. FIAS Occasional Paper 15. Washington D.C. World Bank
[6] Kenya Flower Council Statistics 2007
[7] Kenya flower Council Statistic 2007
[8] Ken Opala. Flower Companies threaten to move to Ethiopia as Council Protest. Daily Nation 4th Feb.2007
[9] Economic Report on Africa 2005
[10] Horticultural Crops Development Authority; www.hcda.or.ke
[11] Kenya Flower Council
[12] Kenya Human Rights Commission: Manufacture of Poverty. The Untold story of EPZs in Kenya
[13] War on Want. Growing Pains The Human cost cost of Cut Flowers in British Supermarkets