



Mobilizing domestic tax revenues for development in Africa

The Issue

One of the key lessons of the 2009 global financial and economic crisis for African countries is the need to pay more attention to domestic resource mobilization. This is because the crisis not only exposed Africa's vulnerability to external shocks but also demonstrated the volatility and uncertainty that surround external sources of development finance, including export revenues, Foreign Direct Investment (FDI), Official Development Assistance (ODA) and remittances.

Financial resources are important for development in Africa, because without adequate financial resources it will be difficult for African governments to implement important economic and social policies and undertake critical infrastructure investments as well as social spending necessary to attain the Millennium Development Goals (MDGs), the objectives of the New Partnership for Africa's Development (NEPAD) and, indeed, sustainable development. However, relying uniquely and excessively on aid is fraught with challenges, besides leading to extreme dependency and increased vulnerability. In any case, despite the debate about ODA to Africa, the amount of aid flowing to African countries is insufficient to make any meaningful impact in addressing the binding constraints to development, especially with regard to inadequate infrastructure. Also, aid volumes are much less than the agreed level by the international community, and well short of the UN target of 0.7 per cent of Gross National Income (GNI) of the major donor countries. Aid delivery is highly fragmented and consequently ineffective. Furthermore, African recipients often face highly volatile aid flows which hamper their budget process and make aid less supportive of economic growth.

It is, therefore, necessary to explore ways of improving domestic resource mobilization. Domestic

resources can come from two sources: private and public. Private revenues come from domestic private savings while public revenues come from taxation or public borrowing. Domestic tax revenues are an essential source of financing for development in addition to the fact that an effective tax system leads to greater ownership of the development process. However, compared to other sources of financing for development such as trade, aid, and debt, adequate attention has not been paid to the issue of taxation. This is a serious challenge for domestic resource mobilization. To address this knowledge gap and provide concrete policy options to increase public financial resources, the *African Economic Outlook (AEO) 2009/10* focuses on "Public Resources Mobilization and Aid." Based on a 50-country study, *AEO 2009/10* presents the analysis of recent trends in tax collection and compares the performance of African tax administrations as well as the key challenges and policy options in tax collection and tax administration.

The Study

Main Trends. The AEO 50-country study finds that tax revenues in Africa have been on the rise and the average African tax revenue as a share of GDP has been increasing since the early 1990s (Figure 1). The study also finds the rate of tax collection in African countries is similar to that of other comparable developing countries. However, this positive trend has been mostly driven by resource-related tax revenues that typically distract governments from generating revenue from more politically demanding forms of taxation, such as corporate income taxes on other industries, personal income taxes, Value Added Taxes (VAT) and excise taxes.

The study further shows two other important features of public resource mobilization in Africa. The first is that countries without large natural resource

endowments have been more effective in collecting taxes and in improving the quality and balance of their tax mix. The second feature is the fact that non-resource related tax revenues have stagnated at best, while trade taxes have declined as a result of trade liberalisation (Figure 2). It should be noted however, that trade liberalization does not always result in reduction of tax revenues. Corporate income taxes are reported to have been resilient, despite decreases in rates at which profits are taxed across Africa, and increases in the number and type of exemption granted by African countries to investors.

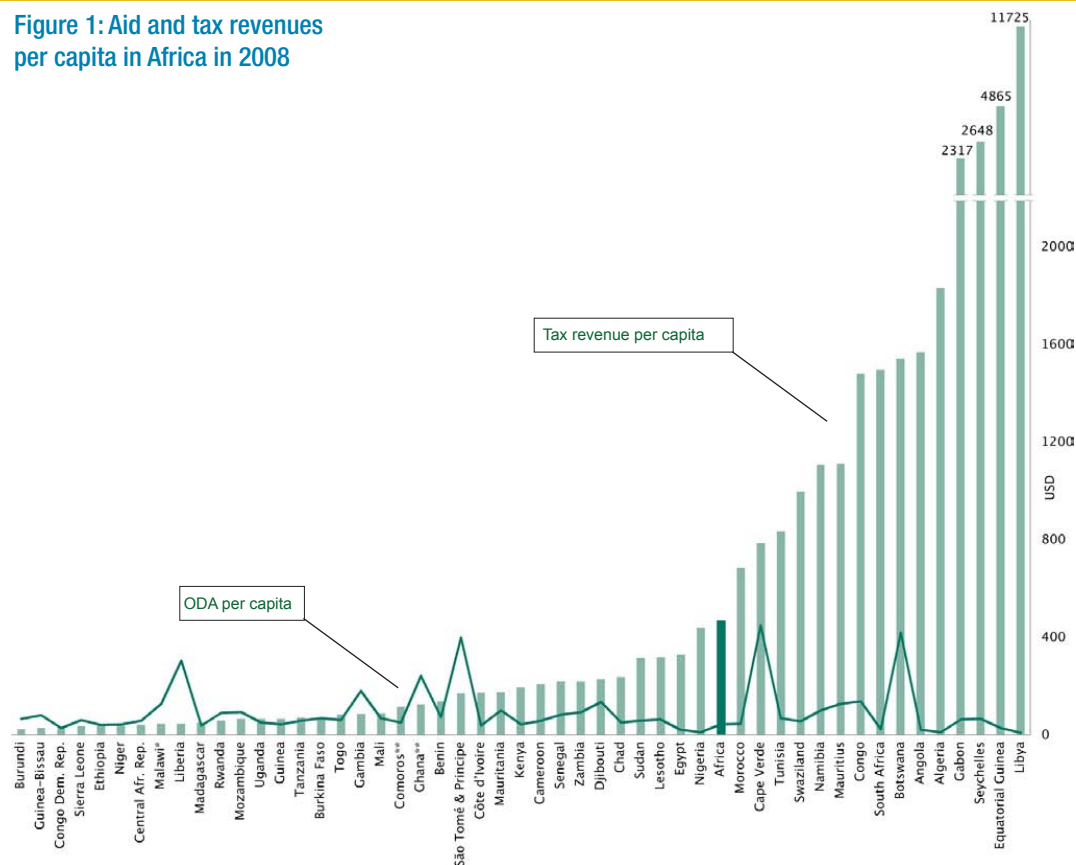
Challenges. The study identifies three types of challenges which African economies are facing with respect to further mobilisation of public resources. The first concerns cross-cutting structural bottlenecks, including high levels of informality, a lack of fiscal legitimacy and huge administrative capacity constraints, against which donor support has hardly been enrolled. Second, the already shallow tax-base is eroded further by excessive granting of tax preferences, inefficient taxation of extractive activities and inability to fight abuses of transfer pricing by multinational enterprises. Third, the tax mix of many African countries is unbalanced: they rely excessively on a narrow set of taxes to generate revenues. This means that some stakeholders are disproportionately represented in the tax base and declining trade taxes leave a critical gap in public resources.

Policy Options

To tackle the foregoing challenges, in addition to reviewing some of the good practices in taxation policies, administration and multilateral co-operation, the *African Economic Outlook 2009/10* presents a number of key policy options which African policy makers and development partners need to note.

- **Taxing for growth.** Tax reform will bring long-term results only if it is visibly linked to a growth and

Figure 1: Aid and tax revenues per capita in Africa in 2008



Notes: (*) 2007, (**) 2006.
Source: African Economic Outlook 2010

employment strategy.

- **Instituting good governance and accountability.** Improving tax collection must be accompanied by a general discussion about governance, transparency and the eventual use of increased public resources by the government.
- **Deepening the tax base.** Administrative bottlenecks are such that in the short-run, deepening the current tax base is the only effective policy option. In particular, countries should consider retrenching tax preferences and negotiating fairer and more transparent concessions with multinational enterprises. As countries embark on economic diversification, proper sequencing of policy reforms is essential.

The annual African Economic Outlook report is jointly produced by the African Development Bank (AfDB), the Organization for Economic Cooperation and Development (OECD) and United Nations Economic Commission for Africa (ECA). The report combines the expertise of the AfDB, OECD, ECA and a network of African think tanks and research centres. Its wide country coverage and methods of analysis are essential for anyone seeking to understand the economic, social and political developments of African countries. More information can be obtained at the website: AfricanEconomicOutlook.org

- *Sequencing trade and tax reforms.* Trade liberalisation needs to be systematically sequenced with domestic tax reform. The policy response to declining trade-related tax revenues has to be designed in the context of a broader reform agenda.

Above all, African countries should pay attention to the development of the private sector in order to expand the tax base.

Implications

Overall, there is improvement in tax collection in the continent, leading to revenue increases. Nonetheless, tax administrators face enormous challenges. The focus should therefore be to develop a strategy for more effective, efficient and fair taxation through deepening the tax base, removing tax preferences, dealing with the use of transfer pricing techniques by multinational firms, taxing extractive industries more fairly and more transparently and addressing capacity constraints of tax administrators.

Based on the foregoing, the natural question that comes to mind is: What are the implications for African countries and their partners? This question is

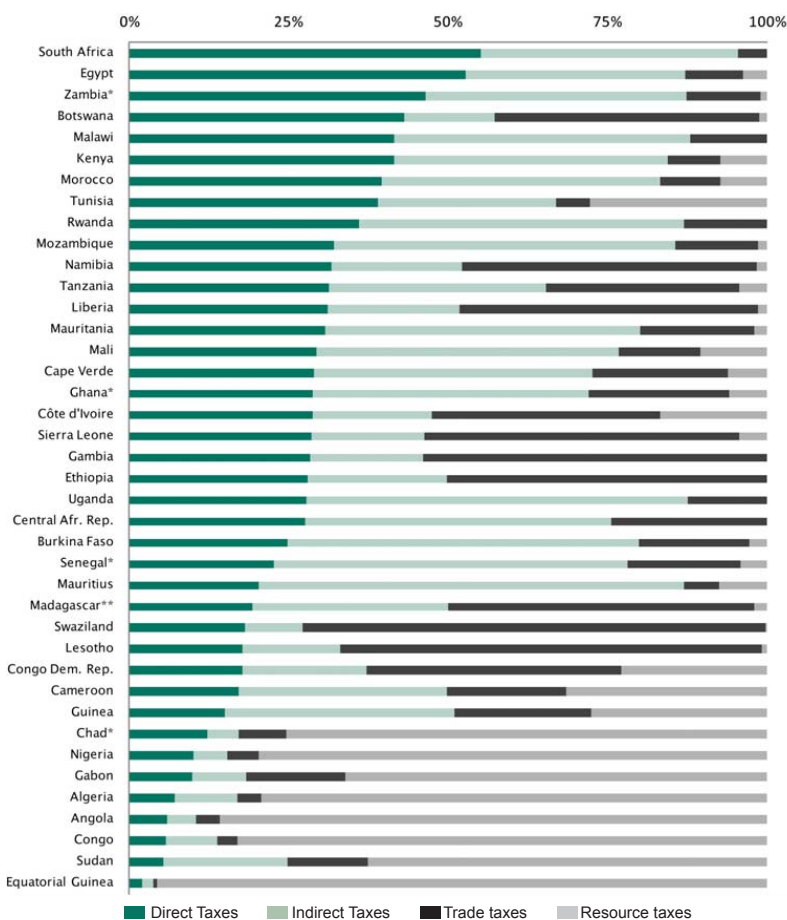
particularly pertinent in light of the global economic crisis, coming on top of the food, fuel and climate change crises, which Africa must find ways to overcome. In addition, capital flight and tax evasion by multinationals are increasingly draining financial resources needed for development in Africa. Illicit capital flows out of Africa have been estimated at over US \$ 800 billion during the period 1970 to 2008. This amount is enough to not only wipe out the region's total outstanding external debt but also to reduce poverty.

Therefore, the trends in and challenges of domestic public resource mobilization in African countries have several implications for implementing recommended policies. First, proposing increased domestic resource mobilization should not be seen as an alternative to aid, which despite its imperfections, has played, and continues to play, an important role in Africa's development. Also, increasing tax revenues should not be seen as the only option for mobilizing high levels of public domestic resources. In many countries, introducing efficiencies on spending could be beneficial and easier to implement. Second, there is a need for strong leadership and commitment to

reforming and developing the needed capacity to implement adequate tax reform policies. Third, there is need for other stakeholders to play their role in supporting the state in this endeavor. In this regard, the African Union, the premier regional organization along with its partners, including the ECA, AfDB and development partners need to intensify their efforts through policy support, knowledge and experience sharing and technical support to African countries in public resource mobilization. ECA for instance, has been playing a key role in supporting the efforts of African countries in domestic resource mobilization in many ways and will continue to do so in line with its mandate. Development partners can do more to build capacity in support of public resource mobilization in Africa. They also need to deliver on their pledges of policy coherence by putting pressure on their own conglomerates to strike decent deals with African nations.

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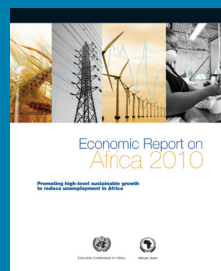
Figure 2: The tax mix in 2007 across African countries: share of each type of taxes in total tax revenues



Source: African Economic Outlook 2010

ECA provides support to African countries in the area of development finance through its analytical work, advocacy, knowledge sharing and technical support. In addition to building consensus and developing common positions regarding financing for development, through its Conference of Ministers, ECA has also built strong partnerships in support of Africa's development by supporting the AU in its engagement in the G8 and G20 processes and in the C10 processes. ECA has also provided technical assistance and direct support to the NEPAD Planning and Coordinating Agency (NPCA), the African Peer Review Mechanism (APRM), and the Regional Economic Communities (RECs).

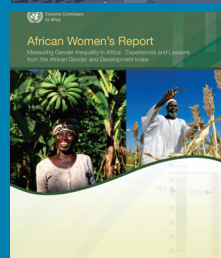
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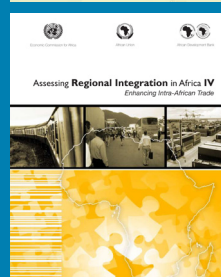
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