United Nations E/ECA/COE/37/13

Economic and Social Council

Distr.: General
28 March 2018

Original: English

**Economic Commission for Africa**
**Committee of Experts of the Conference of African Ministers of Finance, Planning and Economic Development**
Thirty-seventh meeting
Addis Ababa, 11and 12 May 2018
Item 5 of the provisional agenda[*]
**Presentation on the theme of the fifty-first session of the Commission**

# African Continental Free Trade Area: creating fiscal space for jobs and economic diversification

## Key messages

- The African Continental Free Trade Area is a tool for driving African industrialization, economic diversification and development. It will help to promote the type of trade that produces sustainable growth, creates jobs for young people in Africa and establishes opportunities for nurturing businesses and entrepreneurs on the continent.
- The African Continental Free Trade Area will have only a small impact on tariff revenue, while helping to restructure African economies to establish a more sustainable fiscal base. This is because the African Continental Free Trade Area will help to pivot the continent's trade away from extractive sector exports towards more sustainable and inclusive trade that is less affected by fluctuations in commodity prices. In an era of increasingly unreliable aid receipts, and with the growing importance of national resource mobilization, the African Continental Free Trade Area will provide a route towards more sustainable government revenue.
- The ratio of tax revenue to gross domestic product (GDP) is low in African countries, with the ratio for many of them falling below 15 per cent, which is considered to be the minimum threshold for efficient functioning as a State. Strengthening tax administration, closing tax loopholes, improving the efficiency of public spending and tapping into private finance are methods to improve resource mobilization. Doing so can help to develop resources to support the African Continental Free Trade Area and other projects to contribute to the realization of the 2030 Agenda for Sustainable Development.
- To fully utilize the opportunities of the African Continental Free Trade Area, each country should develop a strategy for the African Continental Free Trade Area that complements the broader trade

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policy of each respective State party and that identifies for that particular country the key trade opportunities, current constraints and steps required for it to take full advantage of the African market. Such strategies would be in line with the Action Plan for Boosting Intra-African Trade of the African Union.

# I. Introduction

1. The African Continental Free Trade Area presents an opportunity to leverage trade for structural transformation, economic growth and job creation in Africa. This is because intra-African trade, which the African Continental Free Trade Area will promote, has a strong impact on development. Industrial, value-added and processed agricultural products comprise a far larger share of intra-African trade than the share they comprise of Africa's exports to other regions of the world, around 75 per cent of which are extractives like petroleum oils and minerals. The production of items that are traded among African countries is more labour intensive, thereby helping to generate jobs for Africa's growing population of young people and helping countries to be less impacted by fluctuations in global commodity prices, enabling them to better fuel sustainable economic growth.

2. Although the establishment of the African Continental Free Trade Area may involve adjusting to lower import tariffs on intra-African trade in the near term, in the medium to long term it will offer a pathway to fiscal sustainability. This is because, by stimulating economic growth, the African Continental Free Trade Area will help to generate economic activity in other revenue-generating areas. Moreover, the quality of economic growth that is generated by the African Continental Free Trade Area will allow for diversification away from fiscal reliance on receipts from commodity exports, the prices of which are relatively volatile. As diversification leads to structural transformation, the importance of trade taxes among sources of revenue will decline. However, even in the short term, the revenue currently collected from tariffs on intra-African trade accounts for only a small share of total trade taxes in Africa, and can be partially offset by other taxes, such as the value added tax, which tends to be more efficiently levied on imports.

3. The present issues paper is divided into two parts: the first details the economic and development arguments for the African Continental Free Trade Area and for the prompt ratification of the related legal instruments. The second focuses on the African Continental Free Trade Area as a pathway to fiscal sustainability and the supporting measures that can be used to enhance the fiscal space of and realize fiscal independence in African countries.

# II Economic and development rationale for the African Continental Free Trade Area

## A. Opportunities for African businesses

4. The African Continental Free Trade Area is a tool that countries in Africa can use to create opportunities for African businesses, thereby driving African industrialization, economic diversification and development.

**5.** Africa has an economic size and structure broadly comparable to that of India, with populations of 1.2 billion and 1.3 billion people, respectively (IMF, 2017). The GDP of Africa is $2.5 trillion, while that of India is $2.6 trillion (IMF, 2017). In contrast to Africa, however, India forms a single consolidated market – the seventh largest in the world – allowing for the development of scale economies that have produced some of the largest and most competitive **companies in the world.**

Table 1

**Average tariffs faced by exporters within regions (Per cent)**

| *Region* | *Average tariff on intraregional trade* |
|---|---|
| Africa | 6.9 |
| West Asia | 1.6 |
| East, South-Central and South-East Asia | 4.8 |
| Pacific | 1.2 |
| Latin America and the Caribbean | 6.2 |
| North America | 4.7 |
| Europe | 2.5 |

*Source:* Reference group weighted average tariffs based on the 2013 MAcMap-hs6 database.

6. Conversely, Africa's market is fragmented among 54 countries and 107 unique land borders (see figure I). Businesses face average tariffs of 6.9 per cent when they trade across these borders and non-tariff barriers, like excessive documentation and customs delays, that can be even more burdensome (see table 1). The African Continental Free Trade Area will help to consolidate the African market, making it easier for its businesses to reach greater economies of scale and scope, promoting the development of regional value chains and lowering border costs for trading enterprises, businesses and consumers.

Figure I

**Economic similarities and disparities: India and Africa in 2018**

| **India** | **Africa** |
|---|---|
| **Population** | |
| 1.3 billion | 1.2 billion |
| **GDP** | |
| $2.6 trillion | $2.5 trillion |
| **Tax revenue to GDP** | |
| 20.4% | 20.0% |
| **Internal unique land borders** | |
| 0 | 107 |

*Source:* IMF (2017) (2018 estimates for population and GDP, 2015 for tax revenue to GDP).

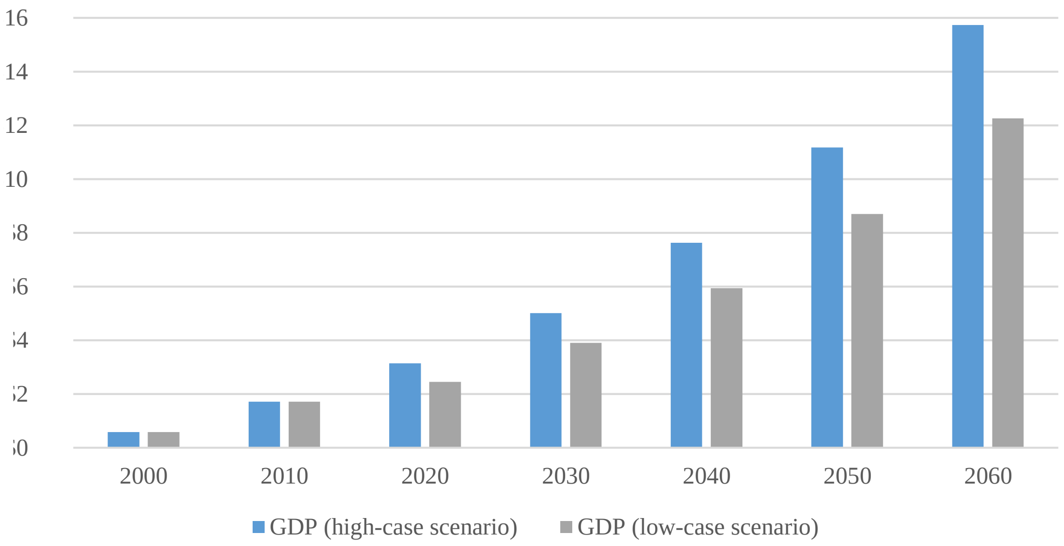
7. It is, however, the dynamics of this potential market that are perhaps the most enticing for African businesses. According to forecasts of the African Development Bank, African GDP is set to grow rapidly, from an estimated $3 trillion in 2020 to as much as $16 trillion by 2060 (see figure II).

8. The African market is expected to grow from a population of 1.3 billion in 2020 to 2.75 billion by 2060 (see figure III). Moreover, this market is becoming increasingly affluent with the growth of the middle class (see figure III).

9. By reducing trade costs and facilitating business expansion, the African Continental Free Trade Area provides significant opportunities for African businesses to gain from, and contribute to, Africa's rapid market growth.

Figure II

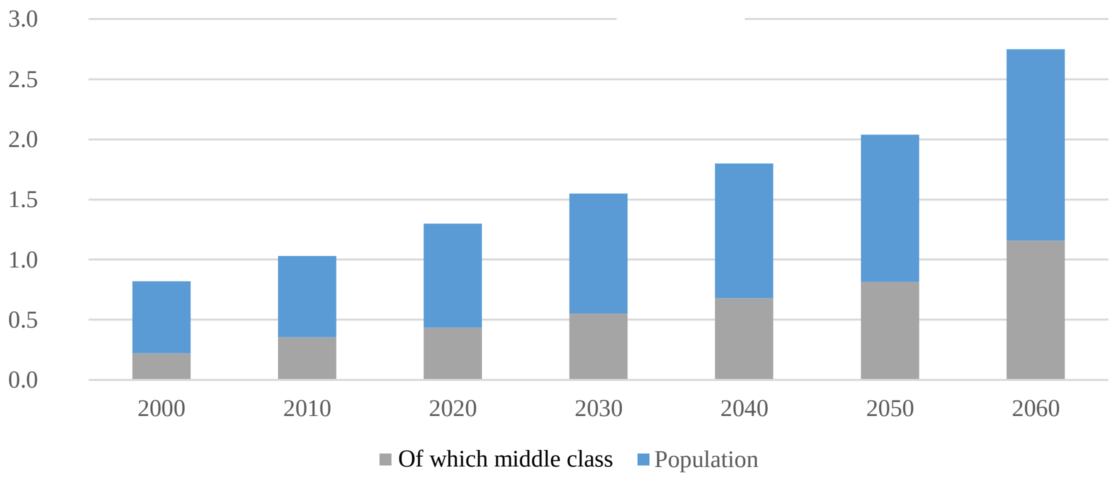
**Forecasts for African GDP at current market prices (Trillions of United States dollars)**




*Source:* AfDB (2011).

Figure III

**Total population of Africa and size of the middle class (Billions of people)**




*Source:* AfDB (2011).

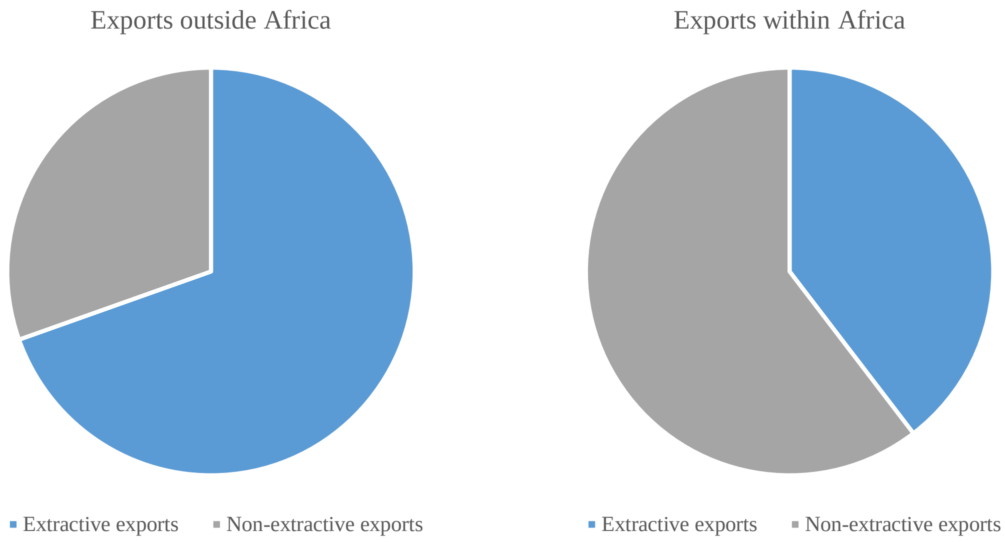
## B. Boosting intra-African trade for sustainable growth and jobs

10. Economic Commission for Africa (ECA) forecasts that Africa's industrial exports are to benefit the most from the African Continental Free Trade Area. The growth of industrial exports is key to efforts to diversify Africa's trade and encourage a move away from extractive commodities, such as oil and minerals, which have traditionally accounted for most of Africa's exports, towards a more balanced and sustainable export base.

11. Between 2014 to 2016, over 70 per cent of Africa's exports outside the continent were extractives, while less than 40 per cent of intra-African trade consisted of extractives.

Figure IV

**Composition of Africa's exports outside and within Africa, extractive and non-extractive exports, 2012 to 2014**

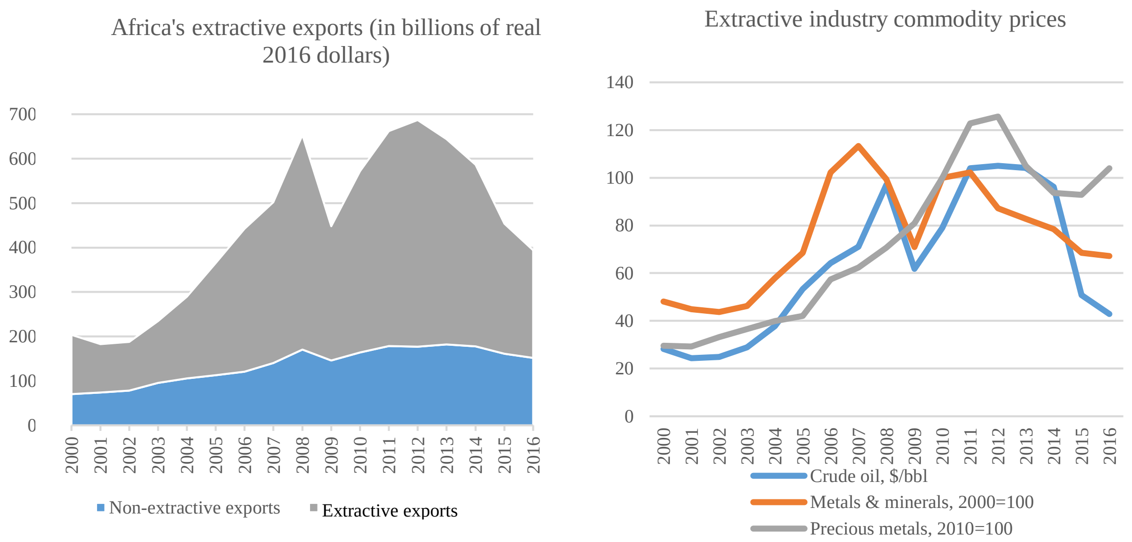



*Source:* CEPII-BACI trade dataset, three-year averaged exports (2014-2016). Extractive exports include petroleum oils and gas; non-ferrous metals, metalliferous ores and metal scrap; crude fertilizers and minerals; coal, coke and briquettes; uranium (the remaining precious metal under Harmonized System Code 71); and basic iron products under Harmonized System Codes 7201 to 7206.

12. The great risk with products like oil and minerals is their price volatility. The fiscal and economic fate of too many African countries relies on the vicissitudes of the prices of such products. Using the African Continental Free Trade Area to pivot away from extractive exports will help to secure more sustainable and inclusive trade that is less affected by fluctuations in commodity prices.

Figure V

**Volatility of extractive exports, 2000 to 2016**




*Source:* Africa's Extractive Exports: CEPII-BACI trade dataset. Extractive Industry Commodity Prices: World Bank commodities market data.

13. Perhaps most important, the African Continental Free Trade Area will also produce more decent-paying and high-quality jobs for Africa's growing population of young people. This is because extractive exports, on which Africa's trade is currently based in large part, are less labour-intensive than those of the manufacturing and agricultural sectors, which will benefit most from the African Continental Free Trade Area. By promoting more labour-intensive trade, the African Continental Free Trade Area will create more employment.

## C. Ensuring opportunities for African countries of different economic configurations

14. Given the significant diversity in the economic configuration of African countries, they will be affected in different ways by the African Continental Free Trade Area. Nevertheless, the benefits from the African Continental Free Trade Area will be widespread, and ECA estimates that all African countries will experience welfare gains provided that the creation of the African Continental Free Trade Area leads to the reduction of tariff and non-tariff barriers.

15. While African countries that are more industrialized are well placed to take advantage of the opportunities in relation to manufactured goods, less industrialized countries can benefit by linking into regional value chains. Regional value chains are formed when larger firms or industries source their supplies from smaller producers or from suppliers across borders. The African Continental Free Trade Area will make it easier to form regional value chains by reducing trade costs and facilitating investment.

16. Agriculture-based economies can gain by satisfying Africa's growing food security requirements. The perishable nature of many agricultural food products means that trade in such goods will be particularly responsive to the improvements in customs clearance times and logistics that are expected from the African Continental Free Trade Area.

17. The majority of African countries are classified as resource-rich countries. Given that tariffs on raw materials are already low, the African

Continental Free Trade Area will do little to further promote such exports. However, by lowering intra-African tariffs on intermediate and final goods, the African Continental Free Trade Area will create additional opportunities for adding value to natural resources and for diversifying into new business areas.

18. Landlocked countries face higher freight costs and more unpredictable transit times than other countries. Landlocked countries will benefit from the reduction of tariffs and from the provisions on trade facilitation, transit and customs cooperation in the Protocol on Trade in Goods.

19. In addition to precautions having been built into the Protocol on Trade in Goods, there are also safeguards to which countries may seek recourse. For example, countries may reserve 10 per cent of the products they import as either sensitive products, which are accorded a longer period for the liberalization of trade, or excluded products, which are not subject to liberalization requirements. Furthermore, least developed countries are to be accorded a more gradual period (between 10 and 15 years) for implementation. There are protections for infant industries and countries suffering balance-of-payment issues and provisions allowing for trade defence measures should surges in imports of a specific product cause or threaten to cause serious injury to domestic producers.

## D. Opportunities for vulnerable groups

### 1. Informal cross-border traders

20. By reducing tariffs, the African Continental Free Trade Area will make it more affordable for informal traders to operate through formal channels, which offer more protection. Those benefits can be further enhanced through simplified trade regimes for small traders, such as the simplified trade regime of the Common Market for Eastern and Southern Africa (COMESA), which provides a simplified clearance procedure, alongside reduced import duties, measures that are particularly helpful to small-scale traders.

### 2. Women

21. Analyses of the impact of the African Continental Free Trade Area at the household level suggest that the effect on male-headed versus female-headed households is quite balanced overall. Both gain by differing degrees in different countries. However, women in particular can benefit from improvements to the situations they face as informal cross-border traders. Women are estimated to account for nearly 70 per cent of informal cross-border traders in Africa, and in such positions they are particularly vulnerable to harassment, violence, confiscation of goods and even imprisonment (Ghils, 2013).

### 3. Young people

22. An estimated 60 per cent of Africa’s population is aged 24 or younger, and many in that age group are about to enter the workforce (ECA, AU and AfDB, 2017). The traditional approach to supporting young people has been through measures that address the labour supply side, by focusing on education, health and the upgrading of skills. However, structural transformation is also required in order to produce new jobs for young people and to absorb such new entrants into the labour force, without which young Africans face the prospect of dangerous migration out of Africa, such as that over the Mediterranean Sea, in search of opportunities elsewhere. The African Continental Free Trade Area can help to reverse that dynamic by contributing to the kinds of export diversification and structural transformation that promote the growth labour-intensive industries that will productively employ a greater share of Africa’s young people.

### 4. Smallholder farmers

23. Smallholder farmers represent some 53 per cent of Africa's agricultural producers (ECA, AU and AfDB, 2017). By reducing trade barriers, the African Continental Free Trade Area can help to connect smallholder farmers to the increasing demand for agricultural products arising from the expansion of Africa's population. In particular, smallholder farms can benefit from simplified rule-of-origin requirements and trade facilitation measures that help them to meet sanitary and phytosanitary export standards.

## E. What must countries do next for the effective implementation of the African Continental Free Trade Area?

### 1. Ensure rapid ratification and conclusion of the implementation road map

24. The African Continental Free Trade Area now rides on the momentum of the successful conclusion on 21 March in Kigali of the tenth extraordinary session of the Assembly of the African Union, during which 50 member States committed to the African Continental Free Trade Area, 44 of which signed the legal instruments of the African Continental Free Trade Area, with an additional 6 declaring their intention to do so after the conclusion of national legal processes. African businesses are showing great interest, political leadership at the highest level is committed and the world is watching.

25. That impetus must be seized. There is a real risk that, without firm ministerial guidance, the process could derail and delays could set in, as happened with the Tripartite Free Trade Area negotiations, which have yet to be concluded despite their launch in June 2015.

26. To bring the African Continental Free Trade Area into effect, countries must first ratify the related legal instruments through their respective national legislative processes. The African Continental Free Trade Area will enter into force once 22 States members of the African Union have deposited their instruments of ratification with the African Union Commission.

27. To operationalize the African Continental Free Trade Area, State parties to the legal instruments must also conclude the implementation road map, which involves developing and submitting schedules of concessions for trade in goods. Each State party or customs union, as the case may be, should specify the particular 90 per cent of total imports that will be liberalized, along with the sensitive products that are to be liberalized over a longer time period and the excluded products that are to be temporarily exempted from liberalization.

28. A related complement to the schedules of concessions for trade in goods is the list of product-specific rules of origin, which, alongside the general rules of origin, will enable the application of preferences under the African Continental Free Trade Area.

29. For trade in services, countries must first agree on which sectors are to be prioritized. Then, they must similarly develop and submit schedules of concessions for these sectors, identifying how barriers to entry, such as local presence regulations, can be eased to allow service suppliers from other African countries to operate locally.

### 2. National strategies and flanking policies in relation to the African Continental Free Trade Area

30. While all countries have something to gain from the African Continental Free Trade Area, it will nevertheless be vital that it is supported with accompanying measures and national strategies to take full advantage of the opportunities arising therefrom.

31. Less-industrialized countries can benefit from the implementation of the Action Plan for Accelerated Industrial Development of Africa. Domestic investments in education and training can ensure that the necessary complementary skills are developed.

32. Implementation of the Africa Mining Vision can complement the African Continental Free Trade Area by helping resource-based economies to strategically diversify their exports into other African markets.

33. The Action Plan for Boosting Intra-African Trade is the principal measure accompanying the African Continental Free Trade Area. The Action Plan outlines the areas in which investments are required, such as trade-related infrastructure, trade information and access to finance, to ensure that all African countries can benefit from the African Continental Free Trade Area.

Box

**National strategies for the African Continental Free Trade Area**

To fully utilize the opportunities of the African Continental Free Trade Area, it is recommended that each State party develop a strategy for the African Continental Free Trade Area that complements the broader trade policy of each respective State party and that identifies for that particular country the key trade opportunities, current constraints and steps required to take full advantage of the African market. Such a strategy might include the following key features:

(a) A review of exports that covers intra-African and global trade performance in the context of an existing trade policy framework;

(b) The identification of export opportunity sectors and prioritization of target sectors under the African Continental Free Trade Area through a statistical analysis of African Continental Free Trade Area market access offers and existing trade potential;

(c) An analysis of constraints faced by exporters in target sectors in their intra-African trade;

(d) Strategic actions to boost identified target sectors that include solutions to identified constraints, approaches to attract sector investment, the prioritization of low-cost interventions and the allocation of institutional responsibilities for strategy implementation.

# III. African Continental Free Trade Area, fiscal space and fiscal sustainability

34. As noted in the first section of the present issues paper, the African Continental Free Trade Area has the potential to contribute to growth and structural transformation in Africa, but also to affect revenue from tariffs on intra-African trade. This section considers the relationship between the African Continental Free Trade Area, fiscal space and fiscal sustainability.

## A. African Continental Free Trade Area and tariff revenue

35. Although removing tariffs on African trade under the African Continental Free Trade Area will reduce tariff revenue, the reduction will be small and gradual for several reasons:

(a) Imports into African countries from other African countries currently account for only 14 per cent of total imports in Africa. Thus, existing tariffs will be retained on the remaining 86 per cent of imports.

(b) A total of 56 per cent of intra-African imports occur within pre-existing free trade areas established by regional economic communities, in which most trade has already been fully liberalized. Tariff reductions will instead apply predominantly to trade among the regional economic communities and trade with African countries that are not part of such pre-existing free trade areas.

(c) Countries will be allowed to exclude a certain number of tariff lines from liberalization. As intra-African trade tends to be highly concentrated in a small number of tariff lines, it may be possible for countries to exclude a large share of the tariff lines that are important for raising tariff revenue. The exact extent of the allowed exclusions, which is to be determined during the next negotiating forum, to be held in May-June 2018, will provide further clarity on the extent of exclusions.

(d) Tariff reductions in the African Continental Free Trade Area are to be phased in gradually, over a period of 5 years for developing countries and 10 years for least developed countries. For sensitive products, there is an even longer phase-in period of 10 years for developing countries and 13 years for least developed countries.

36. Moreover, the net effect of the African Continental Free Trade Area on total government revenue may even be positive, especially over the medium term, for the following reasons:

(a) Import duties are only a small component of government revenue, accounting on average for only 15 per cent of total tax revenue in Africa (African Tax Administration Forum, 2017). This means that reductions in tariff revenue, which are expected to be limited, will affect only a small share of tax generation capacity.

(b) Although the African Continental Free Trade Area will reduce tariff revenue, it is expected to stimulate economic growth by as much as a 1 to 6 per cent of GDP, which would broaden the tax base and boost revenue collection from other sources (De Pietris Chauvin and others, 2016; UNCTAD, 2017). In addition, estimates of the economic impact of the African Continental Free Trade Area are likely to substantially underestimate the true size of the economic gains, since they do not take into account the impact of liberalization in services and investment, alongside a number of other benefits that have not been fully modelled (African Union Commission and others, 2017).

(c) Moreover, the sectors that are expected to gain from the African Continental Free Trade Area, such as manufacturing and agro-processing, are those which tend to produce more sustainable growth, which in turn contributes to fiscal sustainability.

(d) Initial modelling of the impact of the African Continental Free Trade Area on services suggests that further economic gains are likely, which would add to growth and generate additional tax revenue (see Jensen and Sandrey, 2016).

37. In fact, a greater concern than tariff revenue losses may therefore be that overly generous exclusions risk eroding the value of intra-African trade liberalization. In an analysis by ECA, using a partial equilibrium model, it was found that if exclusions are allowed to cover 5 per cent of each country’s tariff lines (equivalent to 260 products), then the African Continental Free Trade Area would reduce tariff revenue by as little as 0.3 per cent for the average African country. If exclusions were further restricted to cover only 1 per cent of tariff lines (equivalent to 52 products), then tariff revenue losses would still amount to only a 2 per cent reduction in tariff revenue for the average African country. UNCTAD found, however, that if countries were to exclude the single most protected sector from liberalization, then the welfare gains to Africa from the

African Continental Free Trade Area would be reduced from $16 billion to $11 billion (UNCTAD, 2017).

38. Exclusions have an important role to play in reassuring less-competitive domestic sectors that may feel threatened by the African Continental Free Trade Area. It is therefore important that, in the upcoming negotiations relating to the African Continental Free Trade Area, countries seek a balance to allow sufficient exclusions to protect vulnerable sectors, without allowing so many exclusions as to erode the value of the African Continental Free Trade Area and hollow it out.

## B. Need to enhance fiscal positions and mobilize additional tax revenue in Africa

39. When the Assembly of the African Union decided to establish the African Continental Free Trade Area at its eighteenth ordinary session, in January 2012, it also endorsed the Action Plan for Boosting Intra-African Trade. It was recognized that free trade alone would not be enough. Sufficient complementary policies would be required to transform Africa's trade and take advantage of the African Continental Free Trade Area. To that end, seven clusters were identified in the Action Plan, addressing investment in productive capacities, trade finance, trade-related infrastructure and trade information.

40. For a number of reasons, it is important for African countries to explore ways to enhance their fiscal positions, including by mobilizing additional tax revenue. First, taking full advantage of the African Continental Free Trade Area will require investing new resources in the Action Plan for Boosting Intra-African Trade. Second, African countries need to mobilize significant additional domestic resources in order to achieve the goals of the 2030 Agenda and Agenda 2063 and to reap the expected benefits from the African Continental Free Trade Area. For the continent as a whole, estimates of the additional financing needed to achieve the Sustainable Development Goals range from $600 billion to $1.2 trillion per year; additional tax revenue are one of the most important means to achieve that end. It is important to note that tax revenue and other sources of domestic financing are far more stable and reliable than external resources. They have the benefit of being under a country's control, allowing the country in question to implement its priority development objectives. It is, therefore, important for African countries to focus on mobilizing additional domestic resources as a means of financing programmes to achieve the goals of the 2030 Agenda and Agenda 2063.

41. Additional resources will be needed to fund public investments, since these play an indispensable role in providing public infrastructure, public services, social safety nets and fiscal incentives for industrial development. While increasing public debt is an option for some African countries to fund investments relating to the 2030 Agenda and Agenda 2063, for several African countries there appears to be only limited scope to expand public debt without compromising debt sustainability (see e.g. African Development Bank, 2018). As such, African countries will need to mobilize additional fiscal resources or other innovative means of funding public spending and investment in order to achieve the goals of the 2030 Agenda and Agenda 2063.

42. In respect of national resources, there are important reasons why African countries need to make efforts to increase tax revenue. The implementation of the African Continental Free Trade Area will provide African countries an opportunity to revisit their fiscal architectures. In particular, the ratio of tax revenue to GDP in African countries is low, and for many, the tax-to-GDP ratio falls below 15 per cent (African Tax Administration Forum, 2017), which is considered to be the minimum threshold for efficient functioning as a State. In addition, despite having low tax-to-GDP ratios, tax revenue greatly exceeds

other important forms of development finance and, as such, may represent the best hope for mobilizing additional funds, since a marginal increase in the efficiency of tax collection may yield substantial sums. On the other hand, other sources (which currently yield lower amounts) would need to increase radically in proportionate terms in order to make a serious contribution to financing the Sustainable Development Goals.

Table 2

**Tax revenue and external financial inflows to Africa, 2011-2016 (Billions of United States dollars)**

| | *2011* | *2012* | *2013* | *2014* | *2015* | *2016* |
|---|---|---|---|---|---|---|
| Tax revenue | 512.7 | 561.5 | 541.0 | 506.4 | 436.8 | 500.0 |
| ODA | 51.6 | 51.8 | 56.8 | 54.3 | 51.2 | 50.2 |
| FDI | 66.0 | 77.5 | 74.6 | 71.3 | 61.5 | 59.4 |
| Remittances | 59.6 | 64.3 | 63.7 | 67.2 | 64.8 | 64.6 |

*Data Source:* UNCTAD (online database for foreign direct investment (FDI)); OECD (online database for official development assistance (ODA) except for the year 2016); AfDB, OECD and UNDP (2017) and AfDB (2018) (2011-2016 data on tax revenue); and AfDB, OECD and UNDP (2017) (data on ODA and remittances for the year 2016).

43. The African Continental Free Trade Area will have only a small impact on tariff revenue, while helping to restructure African economies to deliver more sustainable growth. The African Continental Free Trade Area should be viewed as an opportunity to drive political will to mobilize additional fiscal resources for the Action Plan for Boosting Intra-African Trade and other public projects, which is essential for spurring African development beyond that arising from the African Continental Free Trade Area.

## C. Approaches to mobilizing additional domestic resources, including tax revenue, for public spending in Africa

44. There are a number of approaches that African countries can use to mobilize additional domestic resources, including strengthening tax administration, improving the efficiency of public spending, tapping into private financing to fund public projects, and improving the sustainability of borrowing.

### 1. Strengthening tax administration

45. There is considerable potential to increase the fiscal space in Africa through domestic resource mobilization in order to break away from dependence on declining official development assistance. This can be achieved through modernizing tax administration, improving corporate governance of extractive industries in resource-rich countries, taxing financial transactions and tapping relatively underutilized sources of taxation. In this connection, African countries may consider mobilizing greater revenue through royalties, income taxes, land taxes and leases (African Union Commission and ECA, cited from ECA, 2018c). Also key to broadening the tax base is the formalization of the informal sector, which is largely untaxed. In some countries, the informal sector accounts for between 50 and 80 per cent of GDP, between 60 and 80 per cent of employment, and as much as 90 per cent of new jobs (ATAF, 2017). The challenge regarding taxation lies in the difficulty of bringing informal businesses into the tax net, the low incomes of individuals in the sector and the cost of collection and the administrative burden relative to the sums collected. Some countries have had success in formalizing the informal sector by simplifying the regulatory procedures governing business registration (ECA, 2015).

46. Another way to mobilize additional revenue can be through enhancing tax compliance. In particular, the African Union Commission and ECA (2015) noted that "tax compliance could be enhanced by providing affordable State pensions and other welfare packages, and improved public service delivery [...] because citizens are more likely to pay taxes if they feel that their lives would be improved in return". Doing so would be particularly attractive to those employed in the informal sector, who would see the tangible benefits arising from that new form of citizen-based social contract (ECA, 2018c).

47. Furthermore, African countries can mobilize additional tax revenue by addressing loopholes in tax laws, which create weaknesses in tax policy that constitute key barriers to efforts to enhance revenue mobilization in Africa. Indeed, there are significant loopholes in tax laws in African countries, and the human resource capacities of African tax administrations need to be strengthened (ECA, 2018a). One of the priorities for African countries in closing such loopholes and improving tax administration is to prevent tax evasion and aggressive tax avoidance by multinational corporations, actions which are thought to feed into illicit financial flows. African countries are estimated to lose large amounts of tax revenue as a result of such activities: Africa excluding North Africa is estimated to lose at least 2 per cent of its GDP in foregone tax revenue owing to tax avoidance by multinational firms (Cobham and Jansky, 2017). By liberalizing intra-African trade and investment, the African Continental Free Trade Area may inadvertently create opportunities for multinational corporations to engage in abusive transfer pricing using intra-African trade or other international tax avoidance schemes. That possibility makes it imperative for African countries to take effective measures against aggressive tax avoidance by multinational corporations. In addition, it will be important for measures to be built in to the African Continental Free Trade Area to forestall that risk, including in the investment chapter, which will be negotiated during the second phase of negotiations.

48. It is also important to recognize that harmful tax competition among African countries to attract foreign direct investment is leading to a race to the bottom that is resulting in the loss of tax revenue for all countries in the region (ECA, 2018b). The African Continental Free Trade Area presents an opportunity to address that problem at the pan-African level by means of the competition policy elements of the African Continental Free Trade Area that will be discussed during the second phase of negotiations. Such an approach has been employed in the European Union, where the European Commission has attempted to use European Union competition law to prevent member States from engaging in harmful tax competition.

49. Another policy issue that warrants consideration is the need to eliminate non-strategic tax incentives (i.e., those that are not in the interests of the country granting them, e.g., where they are not necessary to attract investment). Those incentives are often granted without being subjected to cost-benefit analysis and are often not necessary to attract investment anyway (High-level Panel on Illicit Financial Flows out of Africa, 2015; ECA, 2017). Often, the granting of such incentives is the result of a lack of coordination between investment promotion and revenue mobilization objectives.

### 2. Improving the efficiency of public spending

50. Beyond mobilizing additional tax revenue, it is also important for African countries to increase the efficiency of public spending. Some of the approaches that have been recommended in that regard in Africa include ensuring that resource mobilization, budgeting and development planning are done jointly, along with other administrative reforms to public spending processes; reducing the use of official development assistance to support public services; decentralizing public financial management; tackling corruption in public spending; reviewing subsidy and procurement regimes and investment project

approval; and making use of information technology products and digital solutions (ECA, 2018c).

### 3. Tapping into private financing to fund public projects

51. In addition to fiscal resources, there are other sources of financing for public projects that African countries can consider, such as public-private partnerships and innovative mechanisms for encouraging private capital to invest in public projects. Such financing methods can aid fiscal sustainability by reducing the burden posed by spending and investment requirements on government budgets. Such projects face challenges, however, since it can often be difficult for public projects to provide sufficient financial incentives to private sector entities. In addition, as indicated in the Addis Ababa Action Agenda of the Third International Conference on Financing for Development, it is necessary for private and public partners to be thoughtful, in particular regarding the need for fair risk-sharing and accountability, in the design and implementation of public-private partnerships to avoid past pitfalls that have led to the failure of such partnerships. As such, public-private partnerships and innovative sources of financing can be considered to be useful supplementary sources of financing for development. However, they do not remove the imperative for African countries to mobilize additional tax revenue and to improve the efficiency of public spending.

### 4. Sustainable borrowing

52. Governments can also expand their fiscal space through borrowing that is well-targeted and used to boost investment and growth and to generate sufficient future income for the timely repayment of loans. The African Continental Free Trade Area will both create a need for additional investment in infrastructure and private sector development and also provide incentives for African countries to do so in order to benefit from an enlarged export market within the continent and, eventually, to enhance their capacity to compete in markets outside the continent. However, Governments need to be aware of potential risks and to ensure that such borrowing remains within sustainable limits.

## D. Policy issues and key questions

53. The following questions are to be considered for discussion:

(a) How can African countries ensure that their national development planning processes take into account the African Continental Free Trade Area, the opportunities it affords for employment and economic diversification and its implications for public finance? What role, if any, can national strategies for the African Continental Free Trade Area play in that regard?

(b) How can African revenue authorities and ministries of finance improve public financial management through the effective use of information technology, improved coordination between investment promotion and revenue mobilization functions, and the implementation of anti-corruption measures?

(c) How can African countries cooperate at the subregional and continental levels to prevent tax-related illicit financial flows? In particular, how can the investment chapter be used to address weaknesses in existing intra-African bilateral investment treaties that provide opportunities for tax avoidance? How can African countries cooperate to eliminate harmful tax competition on the continent? What role can the African Continental Free Trade Area, in particular the chapter on competition, play in this regard?

(d) Given the use of international index rankings to determine access to international public financial resources and the fact that progress in the implementation of the African Continental Free Trade Area will be tracked through a country business index, how can countries use the implementation of the African Continental Free Trade Area to improve their access to international public financial resources?

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