# Committee of Ten Policy Brief

Nº 2 / 2010



Prepared by: Alex Mubiru

Cleared by : Mthuli Ncube, Chief Economist and Vice President

Léonce Ndikumana, Director, EDRE



#### **Rights and Permissions**

All rights reserved.

The text and data in this publication may be reproduced provided the source is cited. Reproduction for commercial purposes is forbidden.

The Committee of Ten Policy Briefs (C-10 PB) are produced by the Complex of the Chief Economist with contribution from other departments of the African Development Bank. The C-10 PB serves as background material to guide the discussions at the meetings of the Committee of Ten African Ministers and Central Bank Governors.

The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) and do not necessarily represent the view of the African Development Bank, its Board of Directors, or the countries they represent.

The Committee of Ten Policy Briefs are available online at <a href="http://www.afdb.org/">http://www.afdb.org/</a>

Copyright © African Development Bank 2010



### **AFRICAN DEVELOPMENT BANK GROUP**

## Domestic Resource Mobilization across Africa: Trends, Challenges and Policy Options

# COMMITTEE OF TEN MEETING WASHINGTON, DC OCTOBER 2010

Prepared by: Alex Mubiru

Cleared by : Mthuli Ncube, Chief Economist and Vice President

Léonce Ndikumana, Director, EDRE

#### A. Introduction

The global economic crisis has given a new impetus to dialogue on domestic resource mobilisation in Africa, particularly on taxation. Lower export revenues, uncertain future foreign investment and aid inflows amidst generally high levels of indebtedness have raised the importance of increasing domestic resources.

This brief paper presents some general stylized facts about domestic resource mobilization with a focus on taxation in Africa, explores several taxation challenges across much of the continent, and offers various policy options to address them. The paper draws from the African Economic Outlook 2010 (AEO 2010).

#### B. Some Stylized Facts on Taxation across Africa

Based on the 50-country AEO 2010 survey, recent trends in taxation across the continent reveal several stylized facts:

First, the trend of tax revenues on the African continent is positive, with the average tax revenue as a share of GDP increasing since the early 1990s. The tax ratio is the total of all collected taxes expressed as share of gross domestic product (GDP). Collected taxes across the continent increased from 22 percent of GDP in 1990 to 27 percent in 2007, implying that many economies have made noticeable progress in collecting taxes. This ratio is important because it tells how much tax revenue is available to a country's government, taking account of the size of the economy.

Obviously these averages also hide significant differences in the performance of individual countries. For example, classifying African countries according to their level of income shows three different trends in tax ratios. The tax share for upper middle income countries has converged to the tax share of OECD countries, to around 35% (OECD, 2009). Indeed, the OECD un-weighted average was 35.8% in 2007 (Bird and Zolt, 2005). The group of lower middle income countries has a tax share comparable to other countries from other continents in the same income category, around 22%. Low income countries have a much lower ratio, below 15%.

Second, taxes per capita have, in general, been increasing in Africa throughout the last two decades although the increase has been modest in low income countries. Taxes per capita are the annual total of all collected taxes divided by the number of inhabitants. Taxes per capita provide an intuitive measure of the amount of tax revenue available on average to a government for each inhabitant. It is the amount of tax money available for the government to spend on everything ranging from building roads to providing public education on average for each inhabitant.

<sup>1</sup> Countries are classified as 'upper middle income' if their income per capita was between USD 3 856 and USD 11 905 in 2008.

<sup>&</sup>lt;sup>2</sup> Countries are classified as 'lower middle income' if per capita income fell between USD 976 and USD 3 855 in 2008.

To be sure, there are large differences across African countries in per capita levels of tax revenue. In countries like Burundi, the Democratic Republic of Congo, Ethiopia and Guinea-Bissau, annual per capita taxes are as low as USD 11 per inhabitant. At the other end of the spectrum, in countries like the Seychelles, Libya and Equatorial Guinea, taxes reach an annual USD 3,600 per inhabitant. In 2008, Equatorial Guinea collected as much as USD 4,865 per inhabitant, primarily as a result of oil-related tax revenue.

Third, there are large differences in the tax mix patterns in Africa. The tax mix is a telling indicator of the particular purpose for which a tax is imposed as well as its welfare effects, i.e. the costs it imposes on consumers, workers and capital owners (Figure 1). A country like South Africa obtains most of its tax revenues from direct taxation, while countries like Senegal and Uganda rely mostly on indirect taxation. Kenya and Mauritania show a relatively balanced mix of different types of taxes. So does South Africa if the importance of personal income taxes within direct taxes is taken into account. Other countries, however, like Algeria, Angola, Equatorial Guinea, Libya and Nigeria, rely almost entirely on one single type of tax.

The relative importance of trade taxes in the tax mix has been declining in Africa since the mid-1990s. Direct taxes have been moderately increasing and indirect taxes have stagnated. The bulk of the increase in tax revenues is due to a spectacular increase in taxes on resource extraction. These taxes have nearly tripled as a share of domestic income over the past decade. The decline of commodity prices in the second half of 2008 coincided with an interruption of this trend – indicating that revenues from this source depend to a large extent on commodity prices and are vulnerable to price volatility.

Oil producing countries levy a large and increasing percentage of revenues on resource extraction (Figure 2). Other types of taxes have stagnated in these countries in terms of their relative importance compared to the overall size of the economy as measured by the GDP. Non-oil producers have made more modest overall progress in raising the tax ratio and had to rely on other forms of taxation. In these countries, it is the more politically demanding types of taxes – personal and corporate income taxes together with VAT – that have been driving the slow and laborious increase in tax shares. In other words, although oil producers collect more tax revenue, non-oil producers actually have higher quality tax revenues.

The period of analysis covers a commodity boom and the entrance of new oil-producing countries into the market. Chad and Libya provide good examples. Chad began oil extraction in 2003. The country experienced a huge increase in resource-related tax revenues in the period that followed. Other types of taxes stagnated at best following oil extraction. The surge in oil prices also gave hydrocarbon producers higher tax revenues. For example, in Libya the percentage of resource-related tax revenues rose from 20% of domestic income in 1999 to nearly 70% in 2007. In Libya too, other types of taxes stagnated at best following the oil price boom.

With regards to *direct taxation*, its average share of GDP has experienced a small increase throughout Africa in the last decade. This is particularly the case in upper and middle income countries like Botswana, Morocco, South Africa, Tunisia and Zimbabwe.

When it comes to *corporate income tax*, corporate income taxes have been stable across the continent. African countries have granted many tax exemptions to corporations so that actual corporate income tax revenues remained flat as a share of GDP. According to the *AEO* 2010, 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.

Over the last decade, collections from *indirect taxation* (mostly VAT, sales taxes and excise duties) have declined across Africa. Countries that have made significant use of indirect taxation are: Burkina Faso, Burundi, Djibouti, Kenya, Lesotho, Mauritania, Mauritius, Morocco, Mozambique, Rwanda, Senegal, South Africa and Zambia.

Fourth, Africa has experienced a surge in resource-related taxes in recent years. On average, resource-related tax revenues nearly tripled in Africa as a share of national income between the late 1990s and the start of the financial crisis. Although resource-related taxes have declined slightly back to around 15 percent of GDP on average, this is still a very high percentage and this average hides some spectacular numbers in countries like 66 percent in Libya and 39 percent in Angola. The recovery of crude oil prices since 2009 is expected to have contributed to a pick-up in resource-related tax revenues as a share of GDP from its lows in Figure 10.

Fifth, a wide range of tax effort is observes across Africa ranging from about 50% up to 250%-300%. Tax effort is an index measure of how well a country is doing in terms of tax collection, relative to what could be reasonably expected given its economic potential. Tax effort is calculated by dividing its actual tax share by an estimate of how much tax the country should be able to collect given the structural characteristics of its economy. For the purposes of this paper, two measures of tax effort were computed. The two sets of results are illustrated in Figure 3. The first measure of tax effort is based on the country's tax share including possible resource-related tax revenues. The second measure is based on an adjusted tax share that excludes this type of tax revenue.

Some African countries thus collect as little as half of what they would be expected to while others collect up to 2 to 3 times what they would be expected to. Twenty-four countries have a tax effort index (including resource-related tax revenues) higher than 1. Eighteen countries have indices lower than 1.

Figure 3 also shows that for some countries, the measure of tax effort is largely unaffected by whether resource-related tax revenues are taken into account or excluded. Countries like Ghana, Lesotho, Liberia, and Swaziland display a high tax effort regardless of the measure. Other countries such as Guinea, Madagascar and Mauritius have a low tax effort according to both sets of estimates. But there is also a group of countries that switch from low to high when including resource-related tax revenues. This group of countries is formed by Algeria, Angola, Congo, Equatorial Guinea and Nigeria. The case of Chad is a striking example, showing a relatively low tax effort getting even lower when leaving aside oil tax revenue.

#### C. General Challenges for African Policy Makers

*First*, the cross-cutting structural bottlenecks: high levels of informality, a lack of fiscal legitimacy and huge administrative capacity constraints, against which donor support has hardly been enrolled.

- Taxing the informal economy: Africa's vast "informal economy" workers and companies operating outside the reach of the law or public administration is a major obstacle to broadening the tax base and collecting direct taxes. In particular, it poses a wide range of economic challenges: not only are taxes not collected, but informal firms are also often less productive and there are no labor and social protection schemes for workers.
- Quality of tax policies and tax administration: Complex tax codes and high compliance burdens imposed by an inefficient tax administration are powerful incentives for small enterprises to remain informal. For example, country surveys reveal that, in Uganda and Zambia, bureaucracy and corruption are identified as barriers against entering the formal sector. In Togo, informal firms state that complex registration procedures impede their entering the formal sector.
- Tax Administration Capacity: Administrative capacity constraints are generally known to be major obstacles to improving tax policy in Africa. The administrative constraints are such that they limit policy options. Many governments often cite the lack of skilled staff as a major impediment to tax collection. Furthermore, despite great progress in adopting Information and Communication Technology to increase revenue collection, more can still be done across Africa.

*Second*, the already shallow tax-base in most African countries 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.

- Taxing Natural Resources: Vast extractable natural resources oil, gas and minerals are already an essential revenue source for many African nations. But African countries get less money from resources than many other countries in the world. It is difficult to obtain a clear picture, however. Contracts are often subject to strong confidentiality clauses by the companies, governments, investors and banks involved. African governments also often lack capacity to negotiate contracts that allow them to generate fair share of rents from natural resource extraction.
- Tax Preferences Creep-Up: Tax preferences also known as tax incentives grant preferential tax treatment to specific taxpayer groups, investment expenditures or returns, through targeted tax deductions, credits, exclusions or exemptions. Governments may cite various arguments for the use of tax incentives, such as addressing different types of market failures, attracting foreign firms (e.g. Comoros, Cameroon) or stimulating exports (e.g. Namibia). Tax preferences are also used to increase or decrease the progressivity of the taxation system or to benefit some

groups over others for political reasons. Yet, tax preferences are difficult to target and may not yield intended outcomes. Significant tax revenue losses and other unforeseen effects may result instead.

Transfer Pricing By Multinational Corporations: Improper transfer pricing is an international problem that affects developed and developing nations alike. The main beneficiaries are assumed to be tax havens and the multinationals. While there are no solid figures measuring the size of the problem, the issue deserves serious attention from African governments and their development partners.

*Lastly*, the tax mix of many African countries is unbalanced: they rely excessively on a narrow set of taxes to generate revenues. Some stake-holders are disproportionally represented in the tax base. Declining trade taxes leave a critical gap in public resources.

- The imbalances: A balanced mix of taxes can help stabilize public revenues while getting a wider range of contributors. Countries that rely heavily on a single type of tax run several risks. If a shock hits that source of tax, the country could see its public revenues collapse. A volatile tax base also leads to uncertain revenues. The risk can be seen in countries heavily reliant on taxes on resources. The tax revenues of these countries are closely linked to commodity prices and the price of crude oil in particular.
- Declining revenue from trade taxes: As mentioned earlier, trade-related tax revenues in much of Africa have been decreasing over the last decade in the face of trade liberalization. Replacing declining trade taxes is one of the major challenges to African countries already struggling with public deficits and large development needs. Border tariffs, arguably one of the easiest types of taxes to collect, still represent a large share of total government revenues in many African countries, particularly low-income countries.
- Ineffective urban property taxes: Urban property taxes offer a significant, and largely unexploited, opportunity for taxation. According to projections by the United Nations Population Fund (UNPFA, 2007), Africa's urban population will more than double between 2000 and 2030, from 294 million to 742 million. It is becoming urgent to put in place local tax structures that can grow with urban development and the corresponding need for urban infrastructure. Property taxes are a natural candidate as they are one of the few types of tax that is progressive, administratively feasible in Africa and that scales up automatically with urban expansion. Whereas a large number of African countries do apply some sort of urban property tax, the general observation is that property taxes yield revenue well below their potential.

#### D. Policy Options for African Decision Makers and Africa's Development Partners

African decision makers as well as the continent's development partners have several policy options to tackle the various challenges presented in this paper based on good practices in taxation policies and administration from elsewhere.

First, tax reform will bring long term results only if it is visibly linked to a growth strategy.

*Second*, improving tax collection must be accompanied by a general discussion about governance, transparency and the eventual use of increased public resources by the government.

*Third*, proper sequencing of policy reforms is essential. 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.

*Fourth*, developing administrative capacity today is a prerequisite to opening policy options for more progressive tax policies in the medium run.

*Fifth*, African countries need to improve the balance between different taxes in the long run. Urban property taxes for example, could yield a much higher return if decentralised, as local governments usually have a more direct access to the relevant information.

Sixth, trade liberalisation needs to be purposively sequenced with domestic tax reform.  $\Box$  e policy response to declining trade-related tax revenues has to be designed in the context of a broader reform agenda.

Lastly, Africa's development partners can do more to build capacity in support of public resource mobilisation 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.

The order in which these policy options are presented above follows the logical sequencing of a typical tax reform process. In the short term, policy makers should concentrate on ways to deepen the tax base in the most efficient and fairest way – removing tax preferences, dealing with transfer pricing abuses by multinational enterprises and taxing extractive industries fairly and transparently. In the medium run, structural concerns require strategies that target the informal sector, enhance fiscal legitimacy, tap the potential of some sectors such as urban property, boost administrative capacity and harness international cooperation to improving resource mobilization.

In the long-term, however, fine tuning the current tax systems under the current economic structures will not yield substantial increases in revenue. Structural economic transformation will be necessary in order to broaden the tax base. Strategies to achieve this goal include: scaling up infrastructure investment to reduce production and trade costs (thus encouraging investment and trade); promoting private sector development including small and medium enterprises; consolidating governance reforms to improve the efficiency of the tax systems as well and the investment climate (thus encouraging private sector activity and increasing the tax base); and regional integration to increase market size and encourage trade (and thus raise revenue from trade taxes). In addition to efforts by African governments, this strategy requires substantial financial support from development partners to fill the massive financing gaps as well as providing technical

assistance to improve the efficiency of tax systems. These are exactly the areas of focus of the African Development Bank's strategy whose ultimate goals is to help unlock the potential of African countries to achieve high growth, a key condition to sustainably reach higher levels of domestic resource mobilization. Development partners can easily help with such a tax.

#### **Partial List of References**

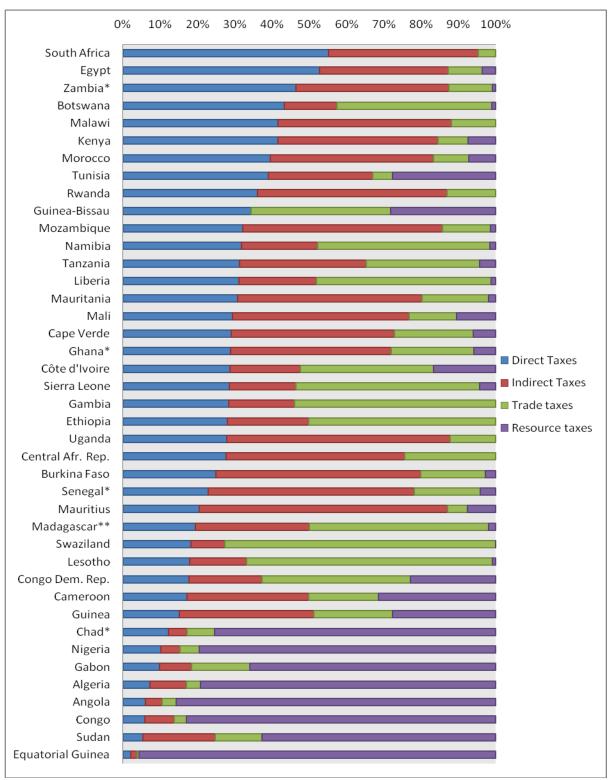
AfDB, OECD and UNECA (2010). African Economic Outlook 2010. Tunis: AfDB.

Bird, R. and E. Zolt (2005), 'Redistribution via Taxation; the Limited Role of the Personal Income Tax in Developing Countries', in *International Tax Program Paper 0508*. Toronto: Joseph L. Rotman School of Management.

OECD (2009), Revenue Statistics 1965-2008, Paris: OECD.

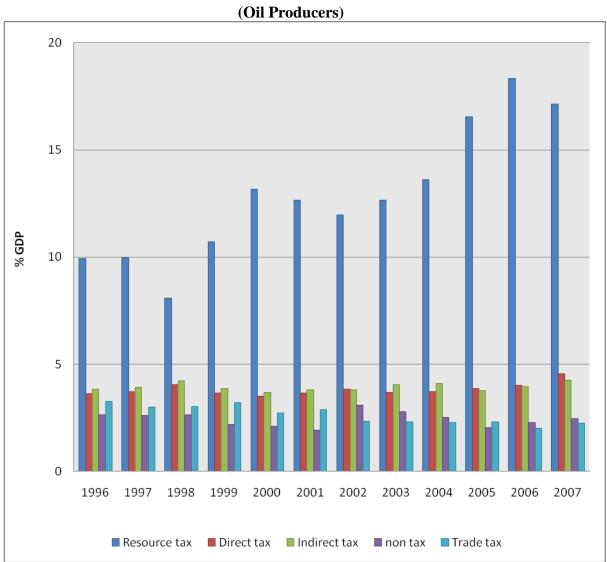
UNPFA (2007), State of World Population 2007- Unleashing the Potential of Urban Growth, New York: United Nations Population Fund.

Figure 1: Vast Differences in Share of Different Taxes in Total Tax Revenues (Tax Mix) Across Africa, 2007



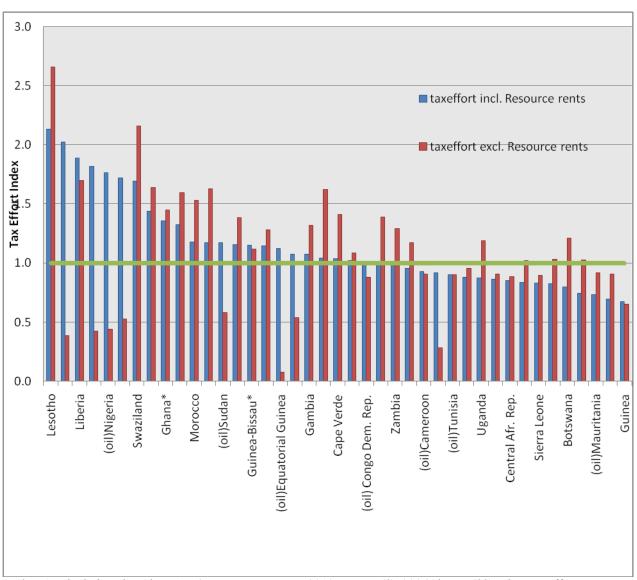
Source: Authors' calculation, based on AEO country surveys, 2010.

Figure 2: Tax Ratios of Oil Producers versus Non-Oil Producers in Africa



Source: Authors' calculation, based on AEO country surveys, 2010.

Figure 3: Tax Effort across African Countries In 2007



Authors' calculation, based on AEO country surveys, 2010 Notes: (\*) 2006 data, (\*\*) The tax effort measures of Botswana, Lesotho, Namibia and Swaziland reflect their membership in the Southern African Customs Union (SACU), which collects customs duties centrally and redistributes them amongst members.



#### African Development Bank

Angle de l'avenue du Ghana et des rues Pierre de Coubertin et Hédi Nouira BP 323 - 1002 Tunis Belvédère (Tunisia) Tel.: + 216 71 333 511 - Fax: +216 71 351 933 E-mail: afdb.org - Internet: www.afdb.org