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Mobilizing Domestic Resource in Africa for Inclusive Growth

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KEY MESSAGES

1. Increased Domestic Resource Mobilization (DRM) would require an efficient, fair, transparent, and accountable system for the use of taxpayers' money, with the view toward increasing voluntary compliance.
2. By eroding revenues, trade liberalization and tariff reduction measures can create demand for greater investment in fiscal capacity building. The African Continental Free Trade Agreement could thus provide the needed incentive.
3. Effective DRM requires a solid database that allows for the identification and location of individuals, firms, or real estate properties on which to levy taxes. Countries must therefore invest in well-managed civil, business, and land registries, while also building efficient address systems.
4. Digital technology offers great potential to improve DRM in Africa, while also presenting an opportunity for enhanced domestic resource mobilization, given the large number of subscribers.
5. Many countries in Africa are still not using best-practice procedures in their tax administrations, suggesting scope for technology transfer and capacity building in this area and, more generally, in public financial management (PFM).

1 | INTRODUCTION

Massive funds are needed to support sustainable development across the world, and in African countries in particular. To raise such amounts, Africa countries will have to step up the mobilization and efficiency of both standard and innovative financing sources.[1] Specifically, domestic resource mobilization (DRM), i.e., increasing government revenues through taxation and other non-debt income sources is essential in allowing countries to own and flexibly chart policies that address their specific development challenges; while mitigating the risks of debt distress.

Many countries have recognized the need to ramp up their capacity to mobilize and efficiently spend domestic resources in their pursuit of poverty eradication and sustainable development. DRM was also identified as the first of six "leading actions" in the consensus declaration of the 2002 Monterrey

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[1] Governments in developing countries typically obtain funding through 4 channels: taxation, borrowing, printing money, and foreign aid. Improving taxation (or more broadly DRM) reduces the need to use the other 3 channels. Innovative financing will refer generally to funding and mechanisms that depart from the traditional sources, such as public-private partnerships (PPPs), pension funds, or carbon markets.

Conference on Financing for Development (FFD). The 2015 Addis Ababa Action Agenda on FFD reaffirmed the urgent need to increase DRM to finance the Agenda 2063 and Sustainable Development Goals (SDGs) in the context of Vision 2030.

It appears obvious that African governments needs to build fiscal capacity with efficient monitoring, administration, and compliance institutions as well as to expand their tax bases. This will be key to go from a position of raising about 20 percent of GDP in taxes to raising about 40 percent, as in some OECD countries. But why have some countries not yet invested in building strong fiscal capacity? The main objective of this brief is to answer these fundamental questions and provide policy recommendations aimed at changing the status quo.

2 | DOMESTIC RESOURCE MOBILIZATION IN AFRICA

Fiscal capacity depends greatly on the level of economic development. For example, historical records indicate that, on average, France, Germany, the Netherlands, and the United Kingdom raised about 12 percent of GDP from tax revenues around 1913, as compared with over 40 percent by 1999. The corresponding numbers for the United States were 8 percent and 30 percent, respectively.[2] And as countries develop, they are able to mobilize even more revenue from their citizens and firms by strengthening their tax systems.

However, fiscal capacity is not only a by-product of development—it is also a key enabler that needs to be actively developed. Tax systems can accelerate economic development through the financing of public goods and investments, and by making the economy more productive or governments more responsive to public welfare.

Over the past 15 years, many African governments have grown wealthier, with increases in both nominal and real GDP. Domestic revenues, including grants, increased by 2 percent, on average, between 2008 and 2016, going from US$497 billion in 2006, to a peak of US$575 billion in 2012, then US$460 billion in 2016, partly due to reduced GDP growth and a commodity price shock.[3] Nevertheless, the amounts raised are not sufficient to meet development needs—particularly when other sources of funding are declining (e.g., aid) or limited (e.g., borrowing and private sector finance).

The average revenue to GDP ratio in Africa has been about 23 percent, between 2008 and 2016 (compared with 40 percent in the European Union in 2016), and with great variation among countries. Countries, such as Algeria, Angola, Botswana, Congo, or Lesotho, had ratios above 35 percent, while others, such as Central African Republic, Madagascar, Nigeria, Sierra Leone, Sudan, or Uganda, had ratios below 15 percent.

Amid these differences, a common feature is the significant reliance on a narrow tax base, namely trade taxes. On average, trade taxation accounted for 44 percent of total tax revenues (excluding grants) in Africa, between 2008 and 2016; while direct and indirect taxation accounted for 28.3 and 22.9 percent, respectively, over the same period. Resource-rich countries, such as Algeria, Angola, Congo, Equatorial Guinea, or Nigeria, obtained over 60 percent of their tax revenues from oil-export taxes.

The heavy reliance on trade taxation indicates relatively weak fiscal capacity. Arguably, collecting trade taxes mainly requires being able to control trade flows at major entry points (ports, airports, or land borders), while collecting income or sales taxes requires major investments in enforcement and compliance structures throughout the entire economy. As countries develop, taxation typically increases in levels but also undergoes changes in patterns. Notably, countries moved away from trade taxes toward broader, non-trade tax bases such as income, property, or value-added taxes.

3 | CHALLENGES IN DRM

Several challenges to DRM in Africa exist, related to macroeconomic factors, government and taxpayers' behaviors, and institutional capacity.

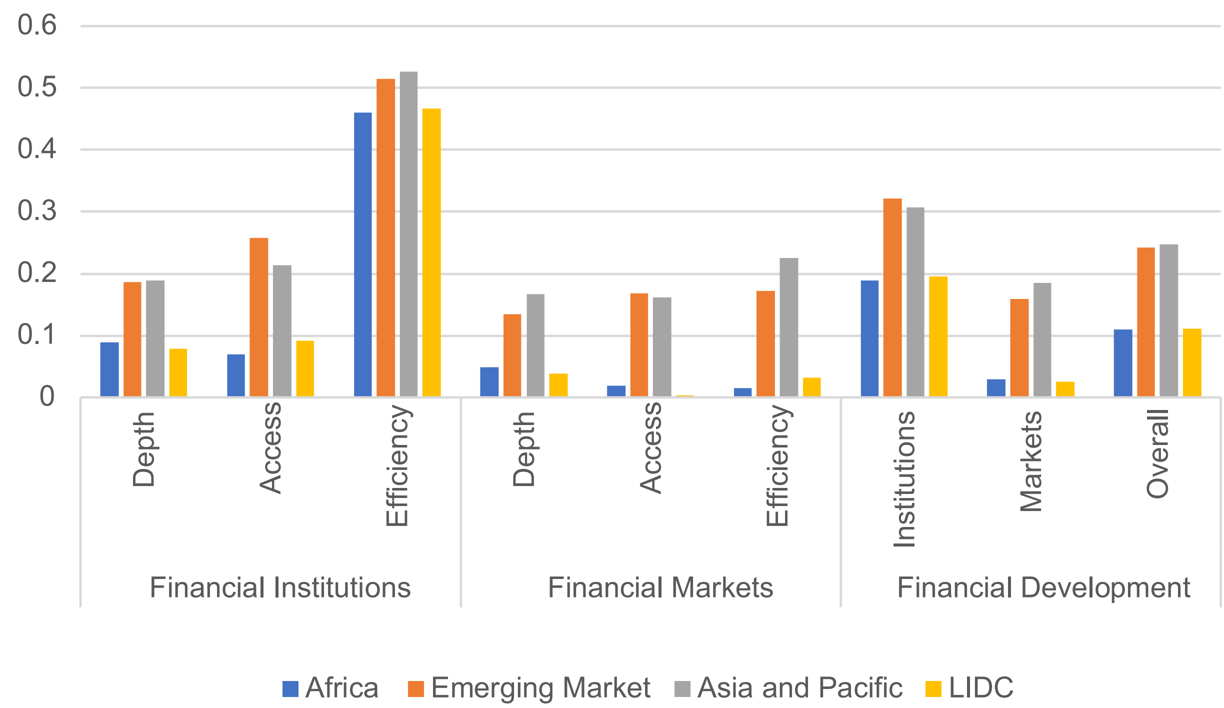
Economic factors

African countries are typically characterized by "hard-to-tax" informal sectors (e.g., small/informal businesses or subsistence farmers), which provide ample opportunity for tax non-compliance due to the lack of information on revenues. The share of informal employment in Africa (85.8 percent of total employment) remains the largest in the world (ILO, 2018).[4] The prominence of the informal sector in most African economies stems from the income-generation or employment opportunities it offers to the unemployed, in particular.

Another issue with domestic mobilization of resource in Africa is the low level of financial development, which neither provides incentives for saving nor efficiently channel these savings to borrowers. While they have deepened substantially in recent years, Africa's financial systems are well below the levels reached in emerging economies or in the Asia Pacific region (see Figure 1).[5] The banking sector is also concentrated in urban areas and often has incentives, and procedures that prevent poorer households and small businesses from gaining access to their services.[6] Low levels

2 See Maddison (2001), p.135. The World Economy: A Millennial Perspective. Paris: Organization for Economic Co-operation and Development.
3 Current United States dollars (US$).
4 ILO, 2018, Women and Men in the Informal Economy: A Statistical Picture (Geneva: ILO).
5 LIDC refers to low-income developing countries, as used in the Global Financial Index/IMF database.
6 Dabla-Norris, E., M. Gradstein, and G. Inchauste, 2018, "What Causes Firms to Hide Output? The Determinants of Informality," Journal of Development Economics, vol. 85, pp. 1–27.

FIGURE 1 FINANCIAL DEVELOPMENT INDEX, 1980–2014



SOURCE Global financial development index, IMF.

of savings deprive governments from savings taxation revenues. The average savings rate on the continent in 1990–2009 was 19.1 percent, with a modest rise to 19.5 percent in 2010–2017, as compared with the Asian Pacific countries, which had 27.9 percent and 30.2 percent, respectively, during the same period. Cross-country variations in saving rates are large though, with the highest-saving countries being Botswana at 42 percent, Zambia and Algeria at 37.2 percent, Cape Verde at 33.3 percent, and Ethiopia at 32 percent of GDP in 2016, respectively.

Government behavior

The "revenue bargaining" theory suggests that the taxpaying process is crucial for explaining the emergence of responsive and effective governments, because it enables a "revenue bargaining" process—defined by Moore (2008) as "the exchange of tax revenues (for the state) for institutionalized influence over public policy (for citizens)."[7] In other words, political accountability from a government to its citizens is contingent on the dependence of the government on tax revenues.

Yet, large non-tax incomes, from natural resources or large inflows of foreign aid, can disrupt this taxation-accountability nexus. This partly explains why some resource-rich and aid-dependent African countries are not investing in fiscal capacity building. If, in addition, rents created by these non-tax revenues flow disproportionately to elite groups, incentives to invest in fiscal capacity building can be further jeopardized.

As a regulator, African governments tend to develop overly complex tax legislation and rules, thereby increasing compliance costs. For example, the world average compliance time is 125 hours, while in Africa it is 135 hours.[8] These cumbersome legislation and rules also tend to encourage tax evasion. They also provide significant latitude for discretion, thus resulting in abuses or corruption. In a 2016 survey conducted by the PWC firm, Angola, Nigeria, and South Africa were identified as the countries that pose the greatest tax challenges. In Nigeria, respondents indicated that regular and detailed tax authority audits and frequently changing legislation were among the most significant issues. The fact that there are three tiers of government in Nigeria with varying taxing powers also tends to create a multiplicity of taxes with associated hurdles.

The prevalence of tax exemptions also significantly undermines duty revenues. While these tax exemptions and incentives aim to reduce the tax burden on certain economic sectors and income groups, they still impose a heavy cost on the government budget. For example, the foregone revenue from Ghana's tax expenditures amounted to an estimated 5.2 percent of GDP in 2013.[9] In Ethiopia, the impact of the tax holidays and exemptions from import taxes was estimated to be between 3–5 percent of GDP in 2013.

7 Moore, M., 2008, "Between Coercion and Contract: Competing Narratives on Taxation and Governance: Taxation and State-building in Developing Countries," Capacity and Consent, vol. 25(3), pp. 34-63.

8 See "The Impact of VAT Compliance on Business" (PwC, at https://www.pwc.com/gx/en/tax/pdf/impact-of-vat.pdf) and "Paying Taxes 2010" (PwC, at https://www.pwc.com/gx/en/paying-taxes/assets/paying-taxes-2010.pdf).

Taxpayers' behavior

The domestic tax bases in most African countries are undermined by widespread tax avoidance and evasion (IMF 2011). According to the 2014/2015 Afrobarometer survey, across 36 countries, nine out of 10 Africans say that not paying taxes is wrong, but only a slim majority (54 percent) describes non-compliance as "wrong and punishable," while 34 percent see it as "wrong but understandable."

The "slippery slope" framework argues that, besides instruments of deterrence, such as audits and fines, the relationship between taxpayers and government affects tax compliance (Kirchler et al., 2008).[10] The framework distinguishes two forms of tax compliance: voluntary and enforced compliance. Voluntary compliance increases with trust in tax authorities, whereas enforced compliance depends on the power of tax authorities to enforce tax payments.[11] The level of tax compliance is jointly determined by the interactions between trust and power, which are both typically low in African countries due to corruption and weak capacity, thereby resulting in low DRM.

Lack of trust and corruption further poses the issue of legitimacy of taxation in some African countries. Authorities are viewed as legitimate when the public sees them as having both the legal and the moral authority for taxation (Tyler, 2006).[12] Legitimacy enhances compliance with the law even when the likelihood of sanctions is low. In contrast, a lack of legitimacy could translate into behavior contrary to that sought, resulting in non-compliance with the law or even increased criminal behavior such as tax evasion.

Capital flight, several times higher than aggregate official development assistance (ODA) inflows, significantly undermines domestic resource mobilization. According to estimates, the continent loses up to US$60 billion annually in illicit financial flows, mainly through abusive transfer pricing, trade mis-pricing, mis-invoicing of services and intangibles, aggressive tax avoidance, and illegal export of foreign exchange.[13]

4 | POLICY RECOMMENDATIONS

This section describes some policy recommendations that could help African countries improve DRM and build fiscal capacity. It should be noted that the continent has in past years recorded an increasing number of successful experiences in mobilizing greater levels of domestic resources.

Promoting voluntary compliance

For African leaders, the impulsion to invest in fiscal capacity may come from free trade agreements, such as the African Continental Free Trade Agreement or the Economic Partnership Agreements. As noted earlier, trade-related taxes constitute a significant fraction of government revenues in most African countries. By eroding revenues, trade liberalization and tariff reduction measures can thus encourage greater investments in fiscal capacity building.

However, given the economic environment in African countries, voluntary compliance will be instrumental in increasing domestic revenue mobilization. Awareness campaigns on the importance of tax compliance could help. More important, governments should visibly use tax revenues for public welfare; e.g., through the provision of quality public goods and services.

Improving the business environment and institutions

In many African countries, tax legislation and rules are overly complex, posing significant threat to business growth in Africa. Transparent and streamlined tax regulations must be adopted, with the view toward increasing certainty around the implementation of legislation, while decreasing tax enforcers' discretionary power. For example, the Seychelles Revenue Commission simplified assessment and payment forms to help small firms (with revenues less than 1 million Seychelles rupees, or about US$112,000) comply. They fill out a one-page tax return form, pay 1.5 percent of their annual turnover as taxes, and do not have to maintain records.

Another avenue to improve DRM is to establish and move the tax administration function out of the Ministry of Finance and place it under the jurisdiction of a semi-autonomous entity. Examples are the South African Revenue Service (SARS) or the Kenya Revenue Authority. Such a reform aims to improve revenue collection and efficiency, fight corruption and tax evasion, and ease tax administration reforms, noting though that there have been varying degrees of success.

Effective DRM also requires a solid database that allows the identification and location of the individuals, firms, or real estate properties on which to levy taxes. In this regard, it would be essential for countries to invest in well-managed civil, business, and land registries, while building efficient address systems. The creation of unique identifiers for individuals, firms, and properties in these registries will also be necessary to facilitate information sharing between different

9 World Bank Public Expenditure Review for Ethiopia (2016), and Ghana (2017).

10 Kirchler, E., E. Hoelzl, and I. Wahl, 2008, Enforced Versus Voluntary Tax Compliance: The "Slippery Slope" Framework," Journal of Economic Psychology, vol. 29(2), pp. 210–225.

11 Power of authorities refers to taxpayers' perception of the tax officers' capacity to detect tax evasion; while trust in authorities stems from citizens' general belief that the tax authorities are benevolent and work beneficially for the public welfare (Kirchler et al., 2008).

12 Tyler, T.R., 2006, "Psychological Perspectives on Legitimacy and Legitimation," Annual Review of Psychology, vol. 57(1), pp. 375–400.

13 African Union Commission/United Nations Economic Commission for Africa (AUC/ECA), 2015, Illicit Financial Flows: Report of the High-Level Panel on Illicit Financial Flows from Africa, commissioned by the AUC/ECA Conference of Ministers of Finance, Planning, and Economic Development.

government agencies, such as tax authorities, statistical offices, and social security authorities, making it more difficult for entities to hide or provide different information to different government agencies, and thereby increasing the likelihood of detecting and punishing fraud.

Taking a broader approach on informal entities

To promote formalization, policy makers could take a broader strategic approach, which would seek to register informal firms, in order to protect their rights, entitlements, and assets as entrepreneurs, not only for the purpose of taxing them. The attractiveness of joining the formal sector can also be enhanced, for example, by providing greater access to (financial) resources and information, pension schemes, social insurance, production capability-upgrading programs, or other incentives, conditioned on registration and through intermediaries such as business associations, NGOs, or local community associations.

Lowering the regulatory burden may also help promote formalization. For example, registration of a business can be a daunting process in many developing countries. The related costs, in terms of money, time, and information acquisition can contribute to firms choosing to remain in the informal economy. Another aspect is the cost of gathering civil documents needed for business registration, such as proof of identity or birth certificates, which can also be cumbersome in some developing countries. As a result, reforms should cover more administrative formalities to further ease entry into the formal sector.

Harnessing digital technology potential

Digital technology also offers great potential to increase DRM, particularly in the way tax administrations can improve their efficiency and help taxpayers comply. For example, digital technology allows pre-filling tax declaration using third-party information, thereby easing the tax compliance burden because taxpayers can simply check and confirm the pre-filled information. E-invoices allow governments to track sales using, e.g., cash registers to record transactions and send information electronically (in real time) to a server accessed by tax authorities. Such a system can greatly improve the administrative efficiency of indirect taxes such as VAT. For success, it is essential that a large majority of individuals and businesses have access to and take up this technology.

Mobile technologies and services also present ample opportunities for DRM, given that transactions are electronic and readily taxable. In 2016, the mobile industry generated $110 billion of economic value in Sub-Saharan Africa, equivalent to 7.7 percent of GDP, and generated about $13 billion in the form of taxation. The expanding mobile money ecosystem offers new opportunities to raise funds. For example, in March 2017 Kenya launched M-Akiba, a government bond sold exclusively via mobile money, which allows small investors to buy bonds for as little as $30.

The mobile sector can help DRM by promoting financial and digital inclusion and improving substantially the efficiency of the financial sector. Specifically, millions of individuals and businesses that have never had access to credit are now able to generate a transaction history, borrow money, and pay it back through their mobile phone. In Kenya, the Commercial Bank of Africa disbursed $400 million in loans in 2015 through M-Shwari.

Fighting tax flight

Regarding tax flight, internationally coordinated actions will be required at the source, in transit, and at the destination of illicit transfers. Measures could entail the obligatory recording of beneficial ownership information of bank accounts, trusts, companies, foundations, and other legal vehicles used by financial centers (including “tax havens”). Information sharing agreements among countries would also help curb tax flight as well as including tax flight as a criminal offense in international regimes and codes of conduct.

Tax administration will need to invest in human, financial, and technological resources for improved performance. Tax inspectors, in particular, will need to be given appropriate incentives to detect tax evasion or reject bribes from non-compliers if caught. Relying on tax inspectors' intrinsic motivation for honesty is clearly not sufficient. Yet, which incentive structure could motivate inspectors to put in such costly monitoring is an important but unanswered question. A program for changing mindsets, such as KAIZEN, could also be implemented while working to create a performance-based culture and strong deterrence institutions.

Engaging in Public-Private Partnerships

Governments can also seek to involve private sector actors into the financing of development projects, given the massive needs. A public-private partnership (PPP), in which the private partner brings capital, can indeed be a powerful tool for off-balance sheet financing of public projects. This justification carries more weight when the public partner is constrained in terms of liquidity and the opportunity cost of fiscal resources is high. Such a partnership with the private sector would be particularly important in the infrastructure sector, where PPP is widely seen as one of the strategies to bring additional efficiency, in terms of building, operations, maintenance, and long-term asset lifecycle management. Yet, attracting private sector participation through PPP requires commercially viable projects and acceptable level of risks.[14]

[14] Although KAIZEN originated in the manufacturing environment, its principles and practices translate well into other work situations.

5 | CONCLUSION

To accelerate Africa's development, DRM reforms will be needed to ensure optimal revenue collection. However, many countries in Africa are still not using best-practice procedures in their resource mobilization processes, thus suggesting scope for technology transfer and capacity building in the area of tax administration, and more generally in public financial management (PFM). Specifically, this includes policy dialogue, capacity building, institutional strengthening, and the promotion of reforms in areas such as domestic resource mobilization, accountability (internal and external audit) functions, national procurement systems, and debt management.