Part Two

Public Resource Mobilisation and Aid in Africa

What is Public Resource Mobilisation, and Why Does It Matter?

Africa is taking a growing role in the world, its population is increasing fast and so too is its need for finance to build for the future: to achieve the United Nations' Millennium Development Goals (MDGs) and close the gap between its infrastructure and the rest of the world's, the continent requires an annual investment of USD 93 billion over the next decade (Foster and Briceño-Garmendia, 2009). In sub-Saharan Africa alone, 3.8 million teachers would have to be recruited within five years to achieve universal primary education (UNESCO, 2009). No economy can afford to fund such development needs primarily from external sources, be they public or private.

Indeed, in 2002, the United Nations' Monterrey Consensus on Financing for Development acknowledged that external financial resources would not be enough to meet the MDGs, and that it was necessary to develop new strategies by mobilising *domestic* resources. Africa is no exception. The global crisis has shown how uncertain external flows are for African governments whose revenues have been badly affected (see Part I). In the long run, greater domestic investment can offset vulnerability as well as strengthen local ownership. Development success stories go hand in hand with better mobilisation of a country's own resources and less dependence on aid and other foreign finance.

Domestic resource mobilisation is the generation of savings domestically - as opposed to investment, loans, grants or remittances received from external sources - and their allocation to socially productive investments within the country. There are two sides to it. The *private* side concerns private domestic savings, which the financial sector (e.g. private banks) channels towards investment. *Public* resource mobilisation is about public savings - the excess of public revenues on current government expenditure. This is what is available for governments to fund public investment in infrastructure, including roads, power plants, schools, health facilities, etc. It originates either from borrowing, e.g. issuing government bonds, or the taxation of individuals and companies.

Mobilising resources for development

	Private	*Public*
Domestic	Domestic private saving	Taxation, public borrowing
External	Foreign direct investment (FDI), portfolio investment, remittances	Foreign aid, public borrowing

This Part of the *Outlook* focuses on the latter. It examines how more "equitable and efficient tax systems and administrations" - which signatories of the Monterrey declaration have committed to secure - can be used to improve funding for Africa's development. It focuses on the effectiveness of revenue collection rather than the quantity and quality of spending, although it highlights their importance. It also discusses how foreign aid affects the mobilisation of public resources.

Why review African tax systems now?

The global economic crisis has revealed the risks for African economies of depending too much on external flows for their revenues. First, the reliance on commodities means many African countries remain vulnerable to upsets from the rest of the world, such as the swings in international prices in 2008 and 2009. Second, although major debt write-offs and the boom before the crisis helped, the risk of over indebtedness cannot be ruled out. With the expected fall in export revenues and return to unsustainable fiscal and current account deficits, international reserves may not be able to protect economies from the shortage of external finance. Third, most African economies – particularly non-oil exporters – are prone to chronic external deficits in the current and trade accounts. Even a small reversal of capital flows can force a domestic contraction, unless accompanied by very large trade improvements. Fourth, following the global crisis, the evolution of foreign direct investment (FDI) into Africa and the rest of the developing world is uncertain over the medium-term. Fifth, remittances from Africans in Europe and North America have become an important supplement to basic incomes, but they have been increasing at a slower pace in recent years, and are set to slow down further. Finally, as highlighted in Part I, Africa is set to receive only about half of the increase in official development assistance (ODA) envisaged at the Gleneagles Group of Eight summit in 2005. Although most donors plan to continue increasing aid, some have not lived up to their promises, and may fall further behind on their commitments as ODA budgets stagnate or shrink. The realisation of this vulnerability has given a new impetus to dialogue on domestic resource mobilisation across Africa, particularly taxation.

The global economic troubles have also stimulated the international dialogue on taxation, in which Africa is increasingly claiming its stake. Confronted by budget deficits, governments are seeking to maximise fiscal revenues by strengthening campaigns against evasion and fraud. The Group of 20 nations has made it a priority to enforce internationally agreed standards against tax havens. The Organisation for Economic Co-operation and Development (OECD) countries are actively seeking to engage others in this dialogue, to build support for wider, more binding multilateral co-operation. Donor countries are stepping up financial and technical support to tax administrations in developing countries. This changing context gives African countries new opportunities to improve tax collection for development.

Africa's taxing question: fiscal legitimacy and the state

Tax is not an end in itself. Development economists have long recognised its importance in the consolidation of a well-functioning state (Kaldor, 1980 and Toye, 1978). A healthy public finance system is needed for rapid, equitable, and sustainable growth: government revenue should adequately finance basic security, education, health services and public investment while avoiding inflationary financing. Taxation is one of the few objective measures of the power and legitimacy of the state (Di John, 2009). In post-war economies, for instance, reconstruction of the revenue base is essential to restore a viable state. Tax revenues are also necessary to fund the military, which ensures that a state can secure its borders. Not only do states rely on tax revenue to function, but taxes are also the primary platform for political negotiations amongst a country's stakeholders. They are part of the social contract between a state and its citizens: taxpayers want to know that everyone is paying their fair share and that the money they hand over is put to good use and not preyed upon by corrupt officials. They are more likely to comply with paying taxes and to accept new forms of taxation if they consider the taxes to be legitimate. This is what is known as "fiscal legitimacy".

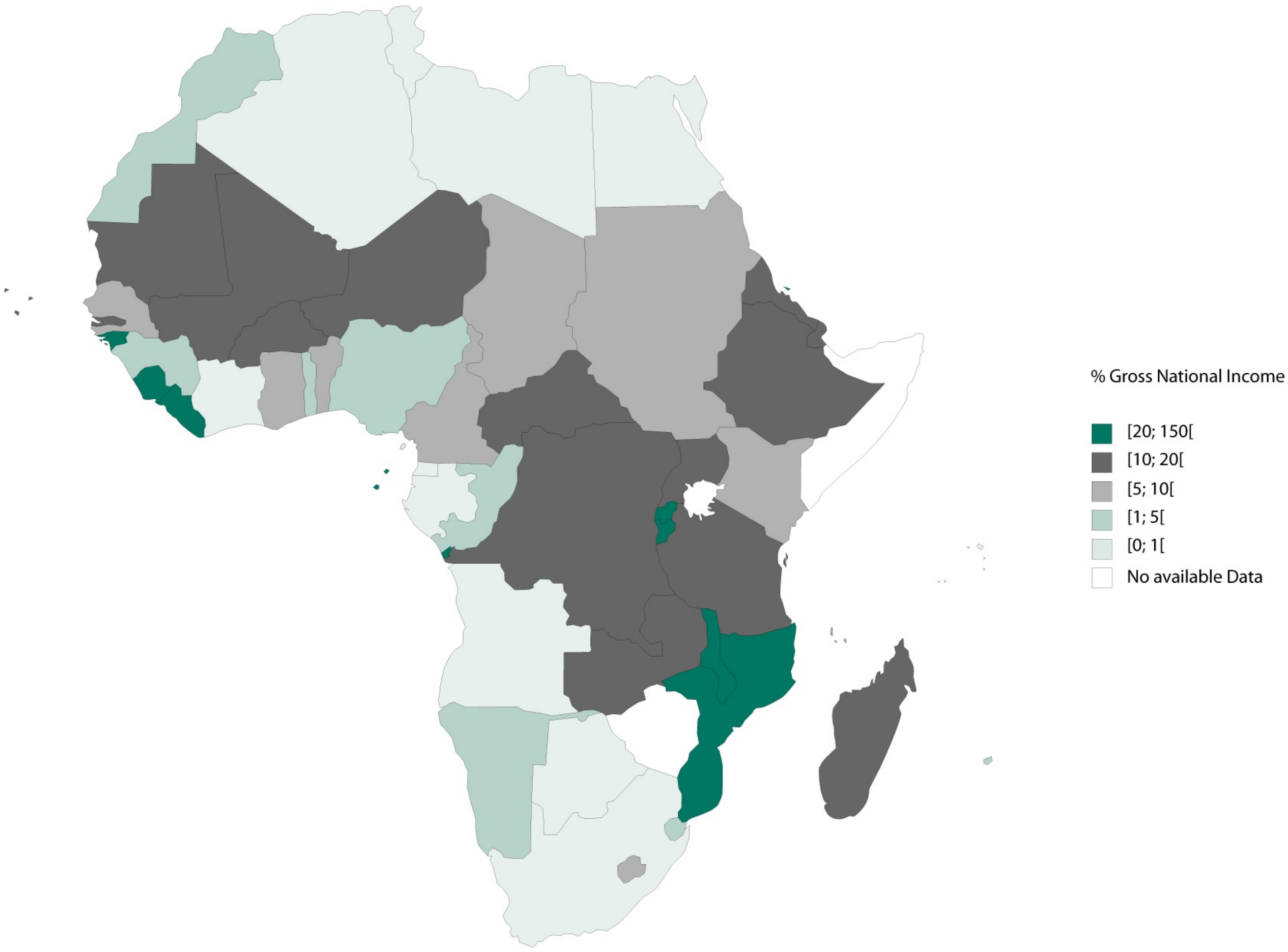
In many developing countries though, poor revenue performance often prevents governments from supplying adequate public services. This creates a vicious circle of dissatisfaction of citizens and firms with those services and a greater willingness to avoid paying taxes. This is largely the result of weak tax administrations, as well as corruption and resistance from ruling elites, who bargain tailored tax cuts and exemptions for themselves and in some cases multinational enterprises. Tax administrations may thus be kept weak because maintaining good relations with donors and large firms exploiting natural resources is easier than being accountable to taxpayers. By contrast, more vigorous taxation and greater fiscal legitimacy implies entering into more constructive dialogue and negotiation with citizens and firms over the spending of taxes collected, with legislators and civil society overseeing tax legislation and government spending. It also requires enlarging the tax base by encouraging the accumulation of capital and the growth of business outside the immediate sphere of influence of the state. Public resource mobilisation therefore goes straight to the heart of Africa's development challenge. But if the aim is legitimacy and greater ownership by a nation of its own development path, does it mean getting rid of foreign aid?

Public resource mobilisation is no alternative to aid in the short run

Africa depends on external resources because domestic savings fall short of current investment needs. Given that this gap will not be closed quickly, most African countries will continue to rely on external resources in the near future. And yet greater independence from ODA is part and parcel of the development process. Better public resource mobilisation is thus not an alternative to aid; they must go together. The challenge is for African countries and their partners to end the vicious circle of aid dependence that shifts government accountability away from citizens towards donors. Instead, they need to start a virtuous circle of aid working to make itself redundant, by supporting public resource mobilisation.

Indeed, aid remains of vital importance for many countries: its share in government revenues is such that if it were to disappear, several states would simply collapse. Figure 1 measures aid dependence as the percentage ratio of aid flows over gross national income (GNI) in countries for which data is available. The most dependent countries are found in sub-Saharan Africa along an arch that crosses the continent from North-West to South-East.

Figure 1: Aid dependance in Africa (2007)



Source: Authors' calculations based on the World Bank's *World Development Indicators*.

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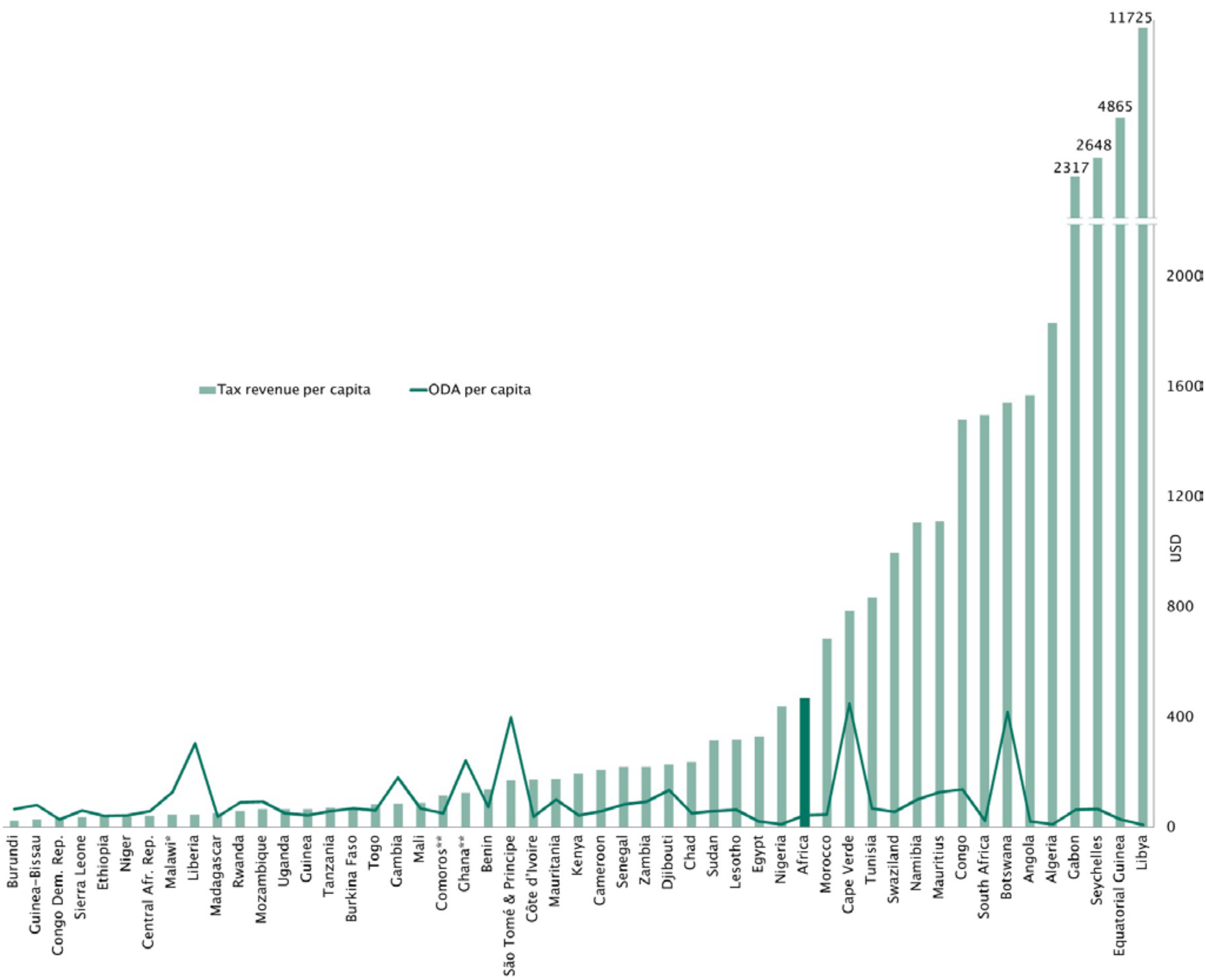
Stimulating public resource mobilisation, the equivalent of increasing the public savings rate, is a necessarily lengthy process. Meanwhile, countries will continue to rely on foreign aid. Yet, the end game should be one in which African countries graduate from, or at least cease to depend upon, aid as a primary source of financing. Mobilising domestic resources better is one way to reduce aid dependency over time. Every effort should thus be made to ensure that aid does not "crowd out", or discourage, domestic resource mobilisation, in general, and public resource mobilisation, in particular. Yet, with so much of Africa's private savings channelled away from productive private investment, or fleeing the continent, the risk of crowding out private savings is relatively limited. Public resource mobilisation actually allows a greater share of savings to remain on the continent and be spent on economic development. One of the dividends of effective tax systems is thus greater ownership of the development process, whereby the government shapes an environment that is more conducive to foreign and domestic private investment, sustainable use of debt and effective use of ODA.

Tax revenues should therefore not be seen as an alternative to foreign aid, but as a component of government revenues that grows as the country develops. Comparing ODA levels with tax revenues in African economies actually reveals that the former is overall much smaller than the latter in many countries. Is that proof that "independence from aid" is within reach in Africa? A closer look at evidence shows a more complex picture.

Figure 2 plots total ODA per capita and total tax revenues per capita in 2008. On average, Africa collects USD 441 of taxes per person per year while it receives USD 41 of aid per person per year. In other words, aid represents less than 10% of collected taxes on the continent as a whole. Of course, the average does not apply to all countries. Of the 48 African countries for which data is available, aid exceeds tax revenues in twelve countries, is larger or equal to half the tax revenues in 24 countries, and exceeds 10% of tax revenues in 34 countries.[1] And yet, in nearly one third of African countries (14 out of 48), aid already represents less than 10% of taxes. Many of those are relatively resource-abundant and/or small in terms of their population (Algeria, Angola, Congo, Equatorial Guinea, Gabon, Libya, Namibia and Swaziland). Figure 2 therefore indicates that, with the exceptions of Egypt, Morocco, South Africa, Seychelles and Tunisia, those countries who made most progress towards "graduating from aid", the "good performers" in terms of tax collection over the last decade, tend to be those who benefitted disproportionately from rising energy and commodity prices. These have generated higher associated tax revenues, as we see in the next chapter.

Figure 2: Aid and tax revenues per capita in Africa in 2008



Notes: (*) 2007, (**) 2006.
Source: Authors' calculations, based on OECD/DAC, IMF's *World Economic Outlook* and *AEO country surveys,* 2010.

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Major findings

Based on the 50-country *African Economic Outlook 2010* survey, Chapter 2 analyses recent trends in tax collection and compares the performance of African tax administrations.

- The trend of tax revenues on the African continent is positive. The average African tax revenue as a share of GDP has been increasing since the early 1990s. African countries generally collect tax revenues similar to those of countries at similar stages of development on other continents.
- 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.

- By contrast, countries without large natural resource endowments have made relatively more significant efforts in improving the quality and balance of their tax mix.
- In fact, non-resource related tax revenues have stagnated at best, while trade taxes have declined as a result of trade liberalisation. 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.

Chapter 3 analyses three types of challenges which African economies are facing with respect to further mobilisation of public resources.

- 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.
- 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. Some stake-holders are disproportionally represented in the tax base. Declining trade taxes leave a critical gap in public resources.

Finally, Chapter 4 provides policy options for African decision makers and donor countries to tackle those challenges, reviewing some of the good practices in taxation policies, administration and multilateral co-operation.

- Tax reform will bring long-term results only if it is visibly linked to a growth strategy.
- Improving tax collection must be accompanied by a general discussion about governance, transparency and the eventual use of increased public resources by the government.
- 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.
- However, developing administrative capacity today is a prerequisite to opening policy options for more progressive tax policies in the medium run.
- In the long run, African countries need to improve the balance between different taxes. Urban property taxes could yield a much higher return if decentralised, as local governments usually have a more direct access to the relevant information.
- Trade liberalisation needs to be purposively 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.
- Donors 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.

In addition to this report, new data on the tax capacity of African states and the key features of tax systems used across the continent can be downloaded at www.AfricanEconomicOutlook.org. In each country note in the *Outlook*, readers will find a section highlighting key developments in tax collection in the national context.

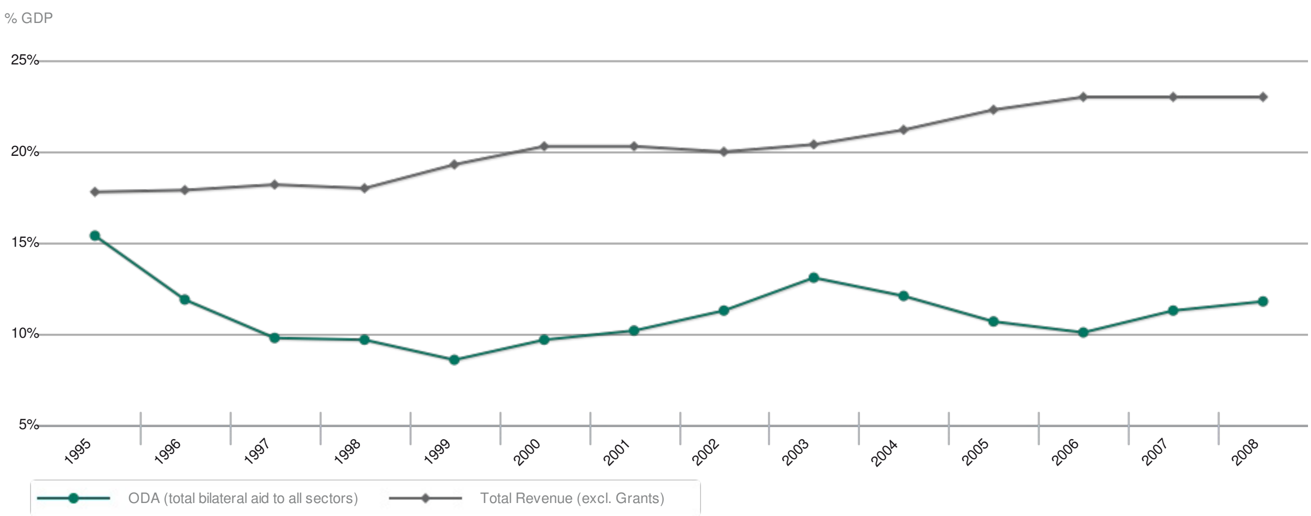
The State of Public Resource Mobilisation in Africa

This section presents a series of stylised facts on the main trends in public resource mobilisation in Africa. The focus is placed on tax revenue, taxes per capita, direct taxation, indirect taxation, trade taxes, and tax effort. The section builds on a data set gathered by the fifty-country survey conducted by the *Outlook*. At the time of final drafting of the Outlook the consistent data ended in 2007.

Collected taxes in Africa increased from 22% of GDP in 1990 to 27% in 2007. Figure 3 illustrates this trend, as well as the growing wedge between fiscal revenues and ODA. However, a closer inspection of the increase reveals that it has been primarily driven by resource-related tax revenues in oil-producing countries. The performance of other types of taxes has been much more modest, as this section shows. Revenue from trade taxes has been declining since the late 1990s but this has been largely offset by indirect and corporate taxes, and resource-related tax revenues. Income taxes (mainly personal and non-resource corporate) have stagnated over the period.

The average growth in tax revenue of African countries in the last two decades also hides significant differences in the performance of individual countries. There is a strong dichotomy between oil-producers and oil-importers, both in terms of collected taxes and the structure of the tax mix. The ability of governments to generate tax revenue from oil can distract them from more politically demanding forms of taxation such as corporate income taxes on other industries, personal income taxes, value added tax (VAT) and excise taxes compared to countries with similar level of tax administrative capacity.

Figure 3: ODA and fiscal revenue as a share of GDP



Source: Authors' calculations, based on OECD-DAC and *AEO country surveys*, 2010.

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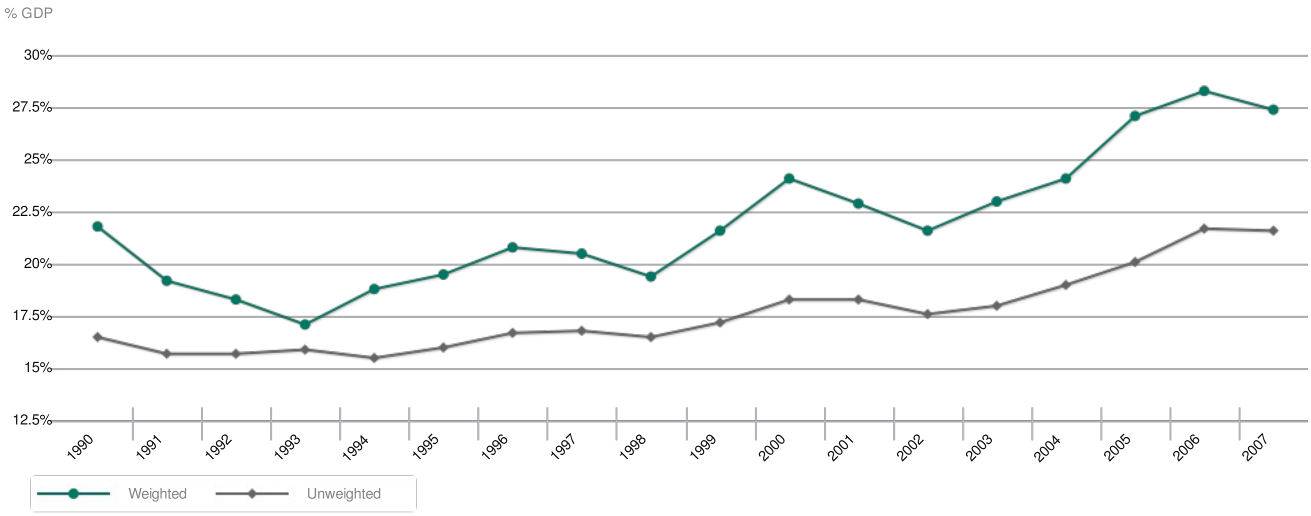
Tax revenue in Africa

The tax ratio is the total of all collected taxes expressed as share of gross domestic product (GDP). The average tax ratio has been increasing in Africa since the beginning of the 1990s, 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. Figure 4 plots the evolution of the weighted and un-weighted average tax shares for the African continent. The tax shares of countries have been averaged by weighting each country's tax share by the size of its economy.

Classifying African countries according to their level of income shows three different trends in tax ratios. [2] Figure 5 plots the tax share over time of African countries when classified in three groups of income per inhabitant. Countries are classified as "upper middle income" if their income per capita was between USD 3 856 and USD 11 905 in 2008. The tax share of this group of countries has converged with the tax share of OECD countries, to around 35% (OECD, 2009a). Indeed, the OECD un-weighted average was 35.8% in 2007 (Bird and Zolt, 2005). Countries are classified as "lower middle income" if per capita income fell between USD 976 and USD 3 855 in 2008. This group has a tax share comparable to other countries from other continents in the same income category, around 22%. For comparison, Bird and Zolt (*ibid.*) estimate that all countries with income per capita below USD 4 900 have an average tax share of 18.3%. "Low income countries" are those with 2008 income per capita of USD 975 or less.

These countries have a much lower ratio, below 15%.

Figure 4: Tax share, 1990-2007, Africa



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

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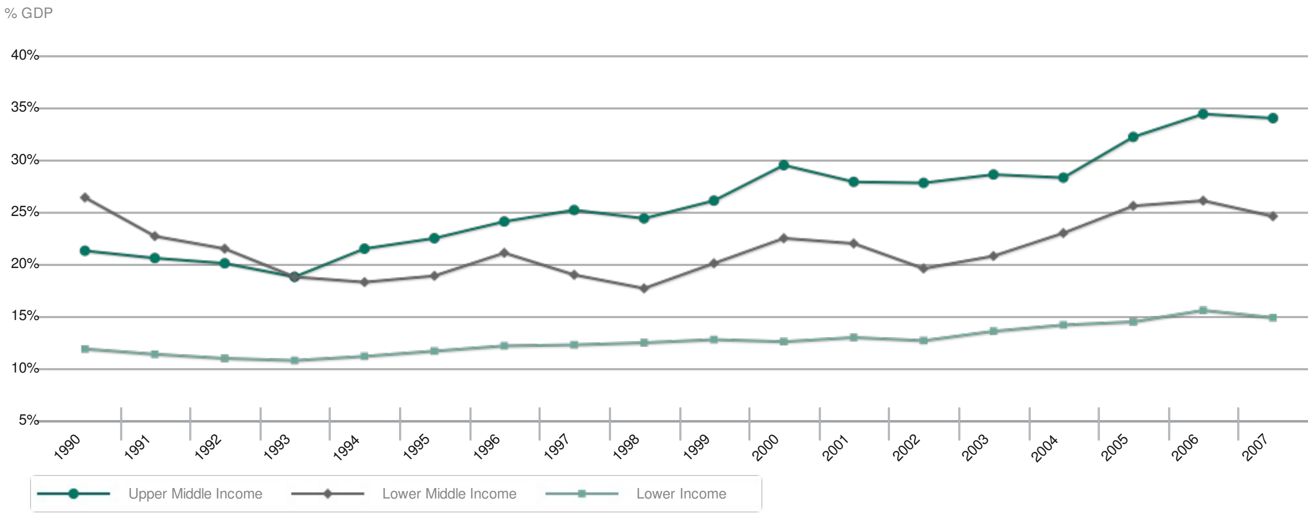
Figure 5: Tax share, 1990-2007, Africa



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

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Taxes per capita

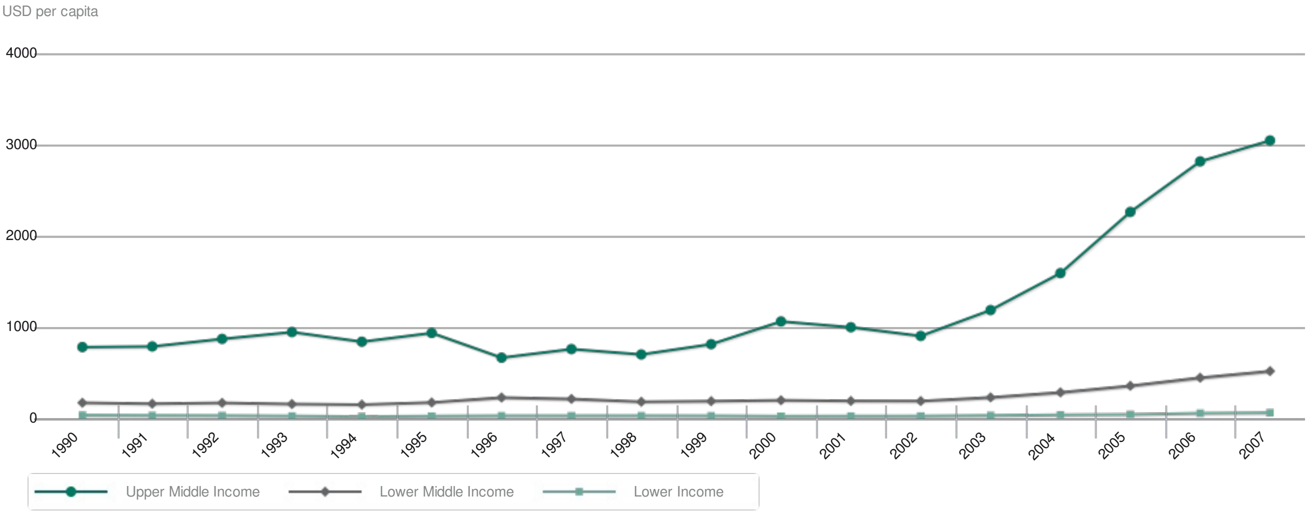
Taxes per capita are the annual total of all collected taxes divided by the number of inhabitants. In general, taxes per capita have been increasing in Africa throughout the last two decades although the increase has been modest in low income countries. Taxes per capita provide an intuitive measure of 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. Figure 6 plots the evolution of taxes per capita (same income groups as in Figure 5).

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. It is difficult to envision any consequential public service delivery with such a small per capita annual public budget. 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.

There is more to taxes than their overall level in a country. To be able to assess a country's tax system, it is important to also look at the relative composition of taxes, *i.e.* its tax mix.

Figure 6: Taxes per capita in Africa 1990-2007



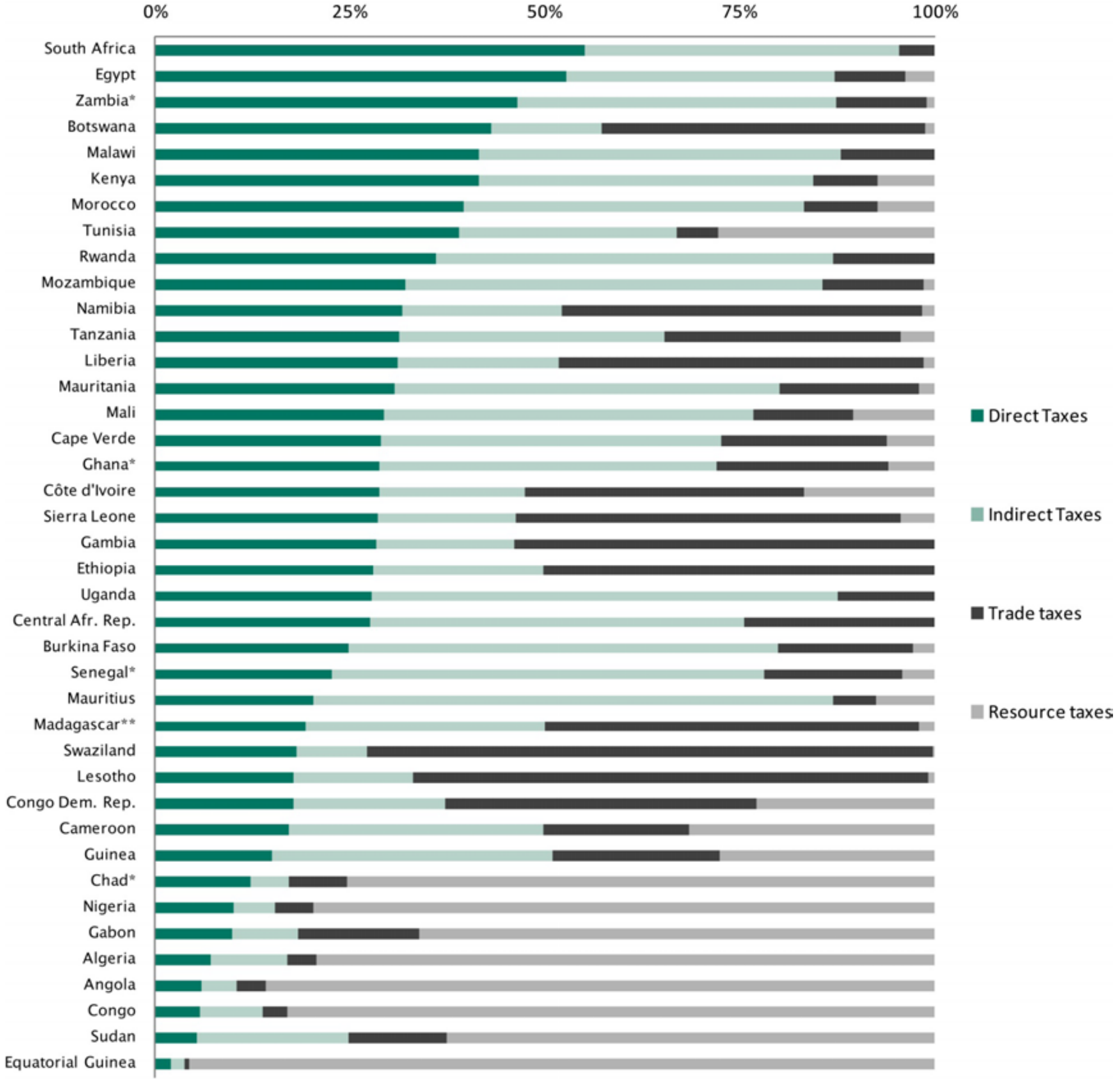
Tax mix in Africa

Modern states typically levy a mix of taxes, including personal and corporate income taxes, broad-based consumption taxes, excise taxes on specific goods or services, payroll taxes, property or wealth taxes, wealth transfer taxes, as well as user fees and benefit taxes. The notion of tax mix refers to the balance of different taxes that make up the tax revenue of a country. Beyond the most obvious purpose of raising revenue to finance public expenditure, taxation is often used to regulate social and economic behaviour and as a tool to shape the distribution of economic resources. 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.

For reference, OECD countries typically tend to rely on a relatively balanced tax mix. It is economically more efficient to do so because the welfare cost of collecting any type of tax increases with the collected amount. First, large contributors to a tax are easy to identify while smaller contributors are typically less profitable to track. Second, taxes generate tax avoidance behaviour which has a cost. Third, political resistance and the administrative costs of collection rise with the amount that is collected. However, it should be noted that average collection costs for a new tax may actually go down before they go up, as there are fixed costs for setting-up administrative capacity (staff, IT systems, etc).

Figure 7 bar-charts the distribution of the tax mix in 2007 as a percentage of total tax revenues in African countries. It illustrates that there are large differences in the tax mix patterns in Africa. 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 almost entirely rely on one single type of tax.

Figure 7: The tax mix in 2007 across African countries: share of each type of taxes in total tax revenues



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

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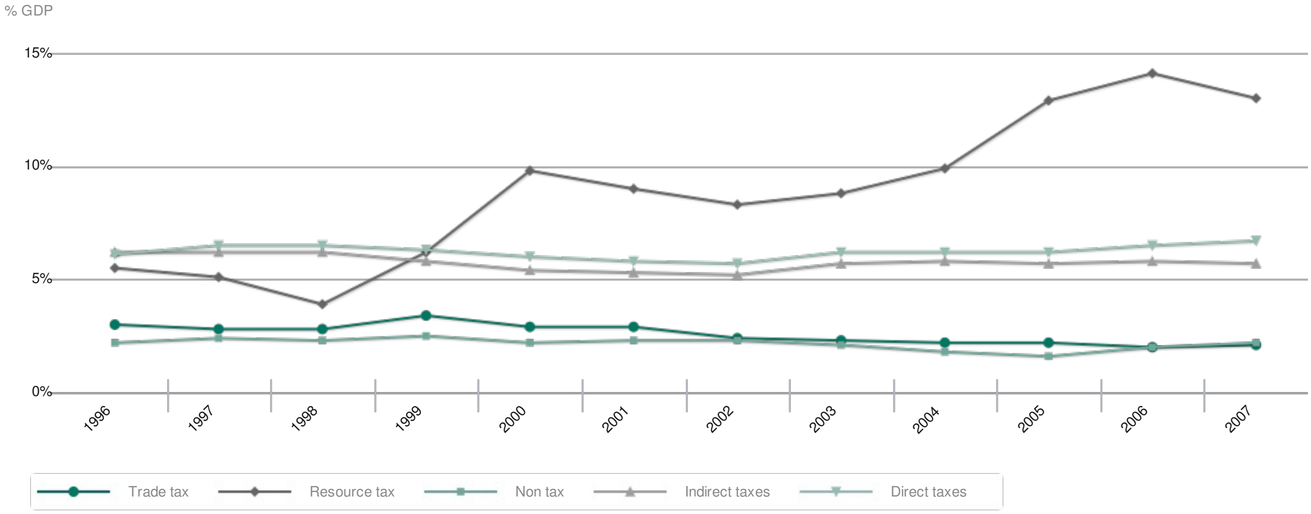
Figure 8 shows the evolution of the tax mix since 1996 with each type of tax averaged across African countries, weighted by the size of the economy, and measured by collected revenues as a share of GDP. Taxes are classified into four categories: direct taxes (mainly personal and corporate income taxes), indirect taxes (VAT, sales taxes, excises etc), trade taxes (customs duty mainly) and resource-related tax revenues. Governments also collect non-tax revenues such as stamp duties. 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.

Figure 8: The Tax Mix in Africa: collected amounts for each type of tax as share of GDP



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

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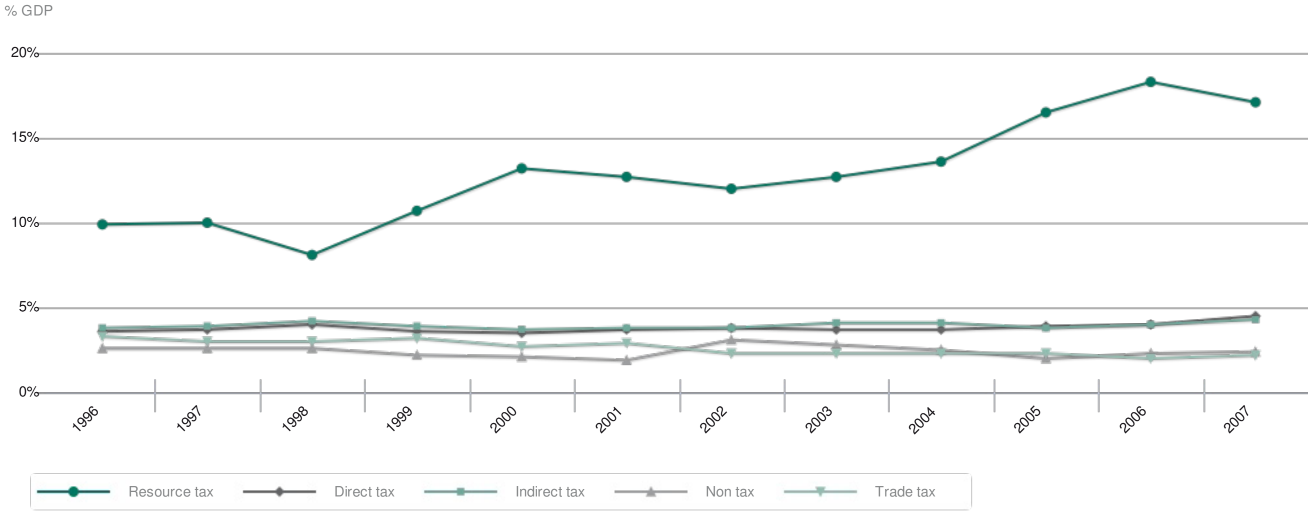
In Figure 9, countries are classified according to whether they are oil producers or not. This classification explains the evolution of the average tax mix in Africa. On one side, oil producing countries levy a large and increasing percentage of revenues on resource extraction. Other types of taxes have stagnated in these countries in terms of their relative importance compared to the overall size of the economy as measured by the GDP. On the other side, 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.

Figure 9a: Tax ratios of oil producers versus non-oil producers in Africa (oil producers)



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

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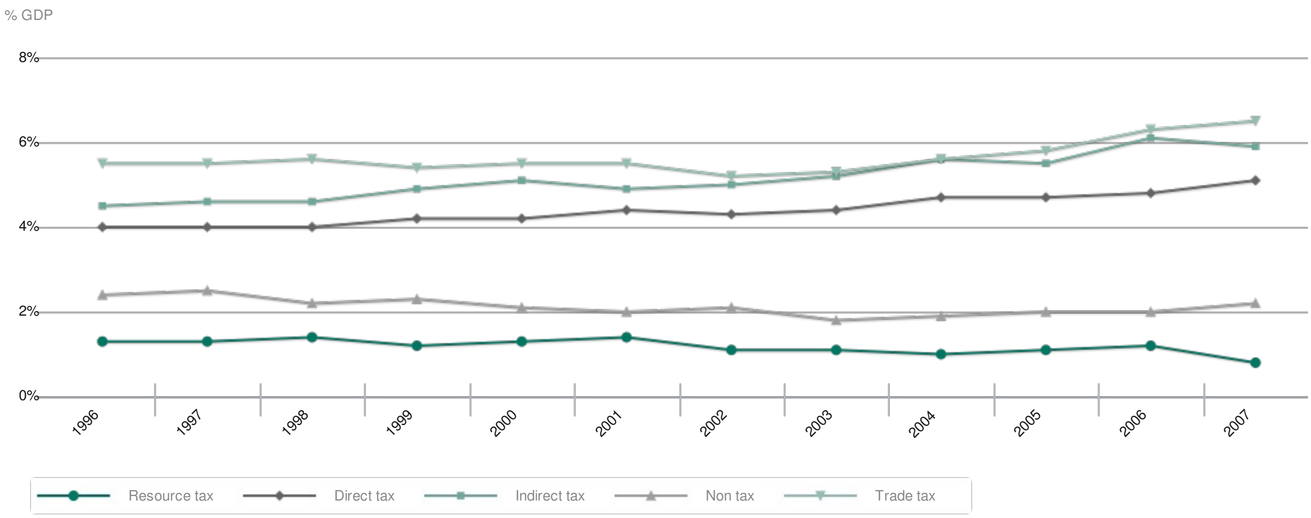
Figure 9b: Tax ratios of oil producers versus non-oil producers in Africa (non-oil producers)



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

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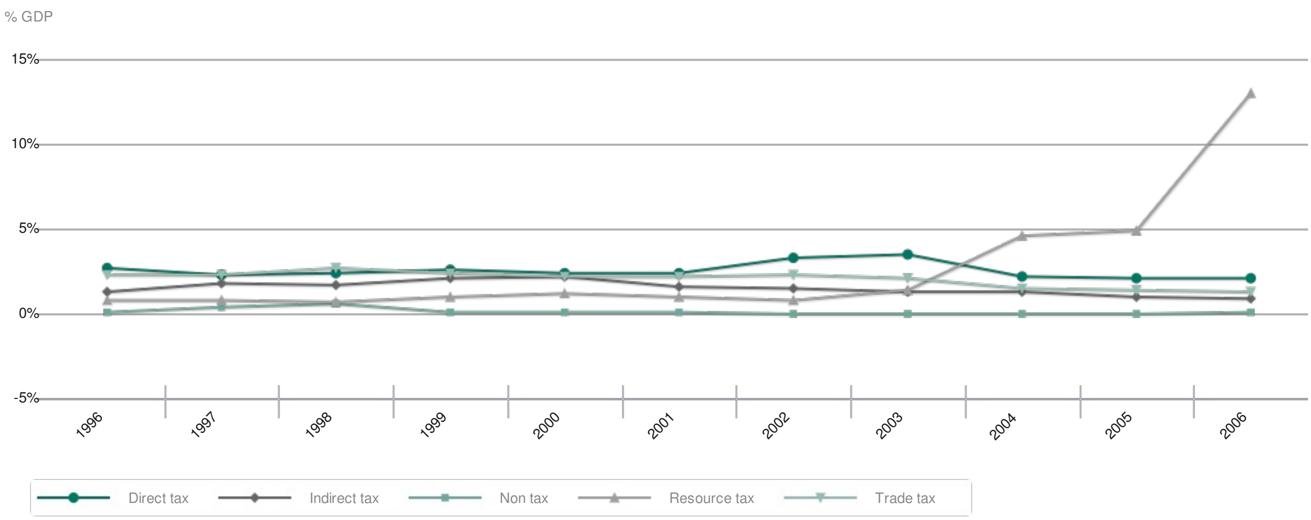
The period of analysis covers a commodity boom and the entrance of new oil-producing countries into the market. Figure 10 provides two examples. Chad began oil extraction in 2003. The country experienced a huge increase in resource-related tax revenues in the period that followed. Other types of taxes 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.

Resource-rich countries, including those who have recently discovered oil or minerals, have a tendency to substitute resource-related tax revenues for other taxes, direct, indirect or from trade. This is the case for Algeria, Angola, Botswana, Congo, Chad, Equatorial Guinea, Gabon, Libya and Nigeria.

Figure 10a: Chad amount collected for each type of tax, as a share of GDP



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

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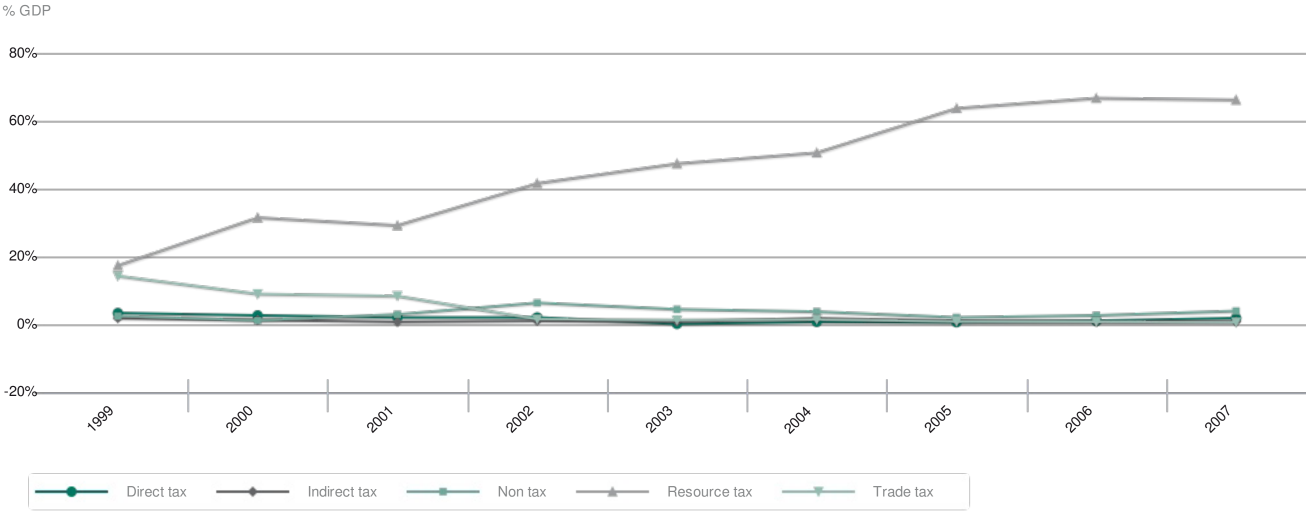
Figure 10b: Libya amount collected for each type of tax, as a share of GDP



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

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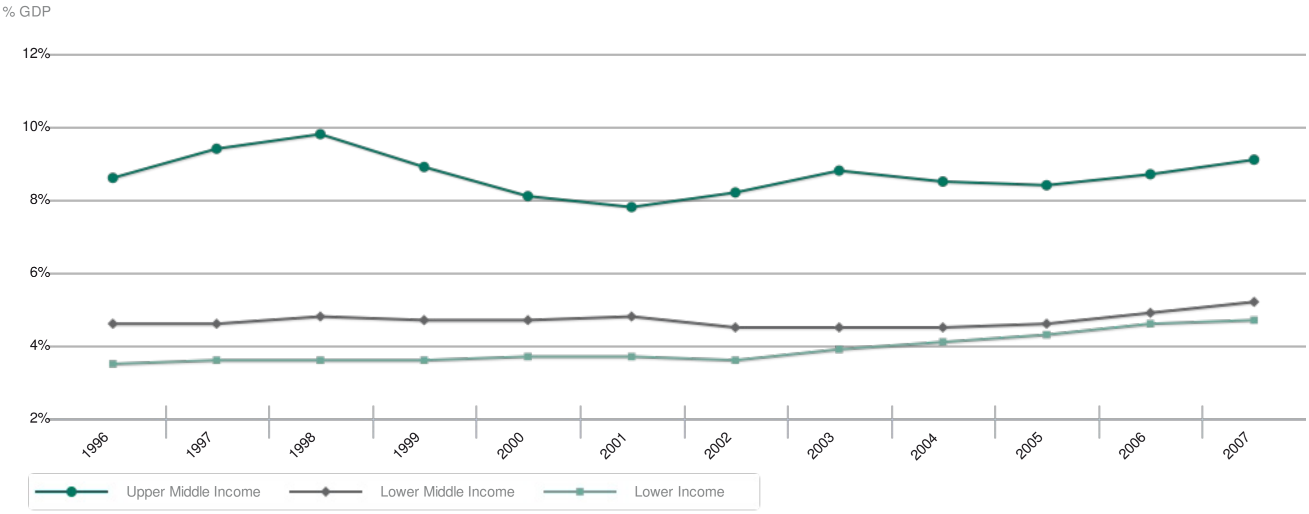
Direct taxation in Africa

Direct taxation consists of taxes levied directly on the income of individuals and on corporate profits. In the last decade, direct taxation as a share of GDP has experienced a small increase throughout Africa, mostly in upper and middle income countries like Botswana, Morocco, South Africa, Tunisia and Zimbabwe. Overall, however, the trend in direct taxation has been flat, as Figure 11 shows.

Figure 11a: Direct taxation in Africa, direct taxes as a share of GDP, average across Africa



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

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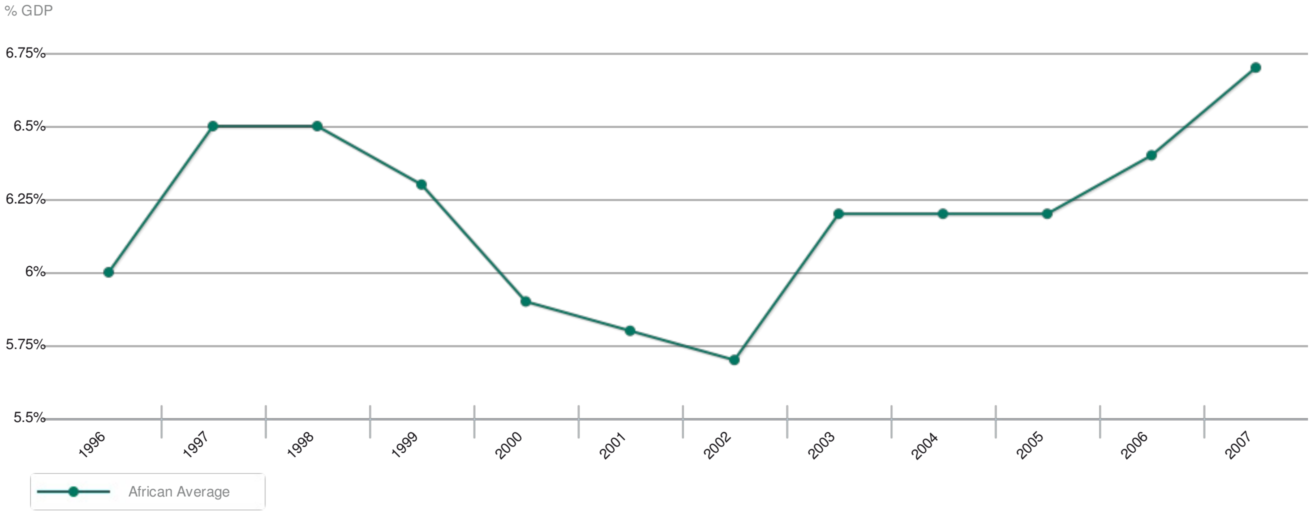
Figure 11b: Direct taxation in Africa, direct taxes as a share of GDP, average across Africa



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

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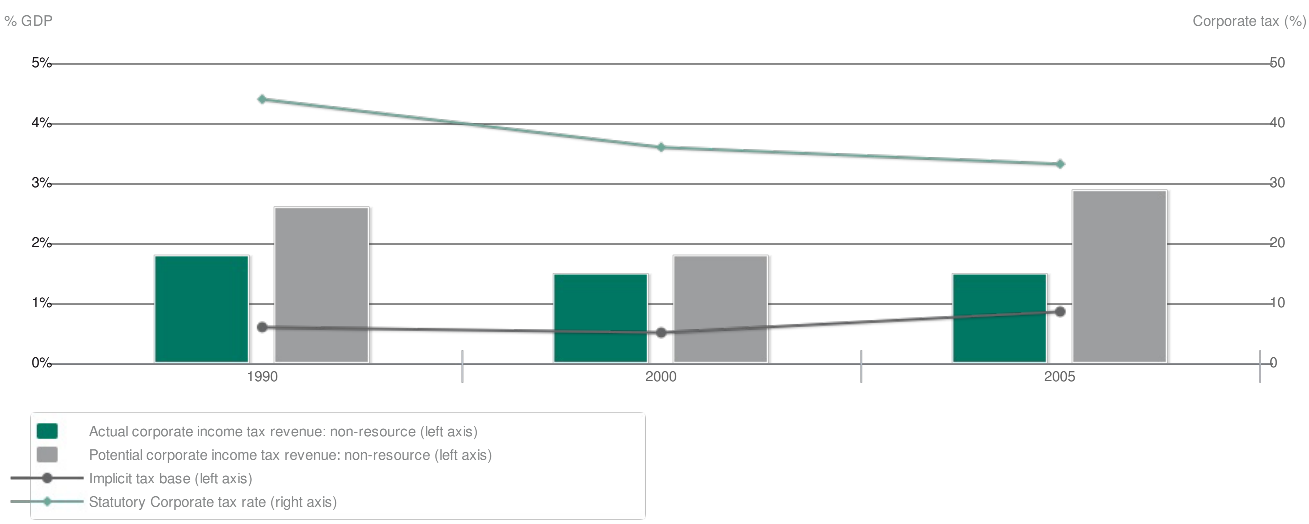
This Outlook survey contains evidence that African countries are slowly lowering their overall personal income tax rates in an attempt to broaden their tax base. Most countries apply a progressive rate ranging from 0% to 35%. Others still have a long path of reform ahead. For instance, Togo recently lowered its rate from 45% to 40%.

Corporate income taxes have been stable across the continent. Figure 12 sheds light on the underlying trends behind this stability. First, the implicit tax base – defined by the authors as revenue, relative to GDP, divided by the (highest) statutory rate – has risen due to a rise in the share of profits in national income in African countries. Second, statutory corporate income tax rates, on the other hand, have been reduced. Combined, these two trends resulted in a net rise in the corporate income tax revenues that could be potentially raised. The third trend, however, is that African countries have granted many tax exemptions to corporations so that actual corporate income tax revenues remained flat as a share of GDP. This Outlook survey shows that 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.

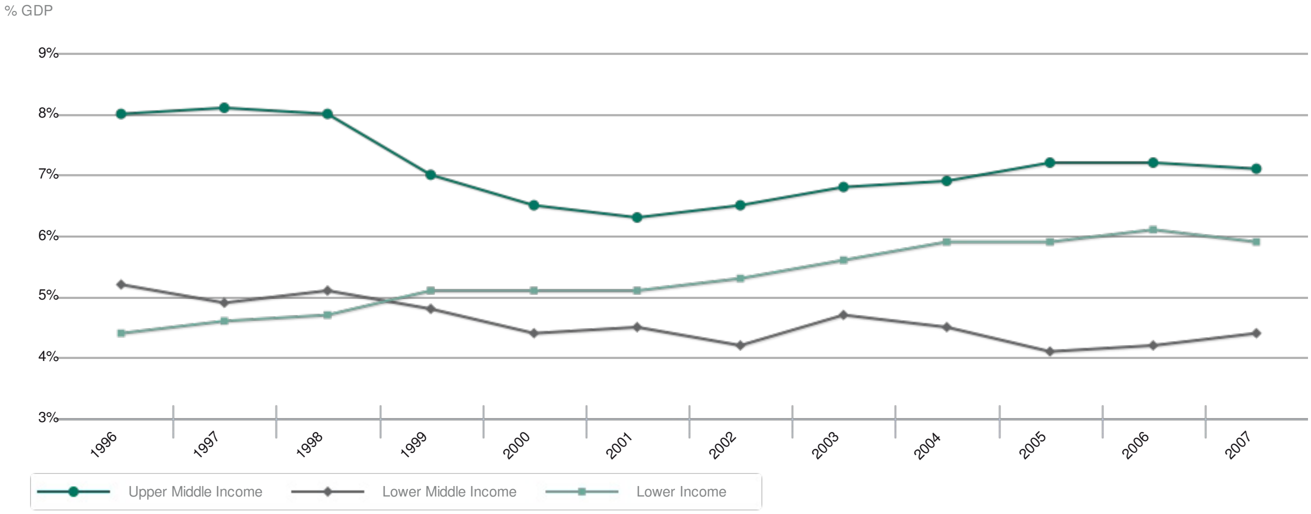
Figure 12 : Evolution of corporate income taxes in Africa



Indirect taxation in Africa

Indirect taxation refers to taxes on consumption collected on behalf of a government. These include VAT, sales taxes and excise duties. Figure 13 shows that during the last decade indirect taxation as a share of GDP has decreased marginally in Africa. This trend is noticed when countries are weighted according to the size of their economies. 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. As can be seen in Figure 13, low income countries in Africa seem to make more use of indirect taxation than slightly richer countries

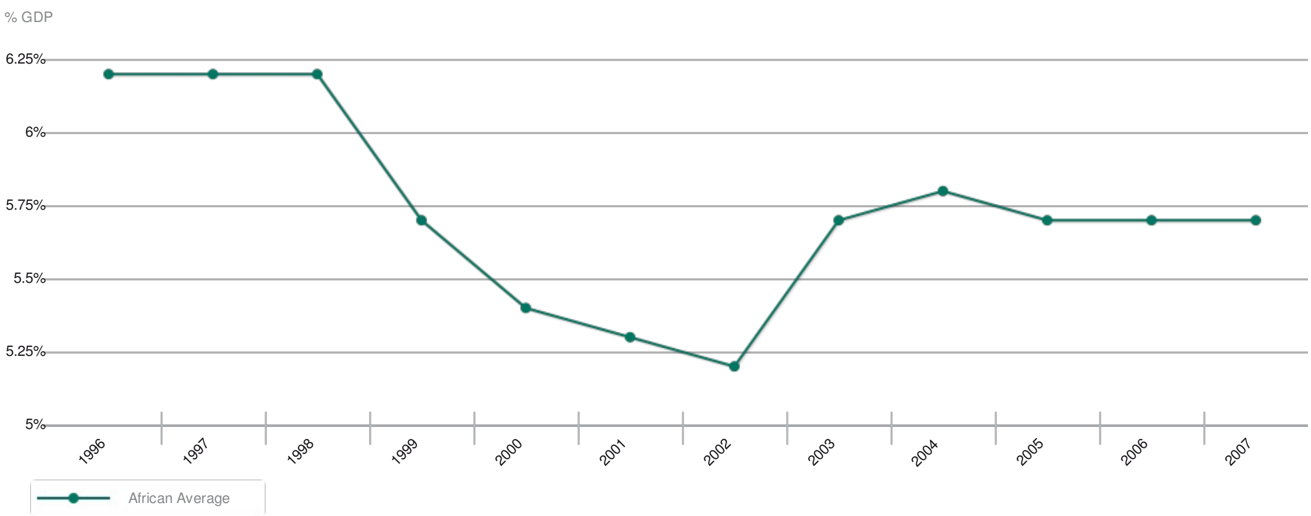
Figure 13a: Indirect taxation in Africa - Collected indirect taxes as percentage of GDP



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

StatLink http://dx.doi.org/10.1787/848403703464

Figure 13b: Indirect taxation in Africa - Collected indirect taxes as percentage of GDP



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

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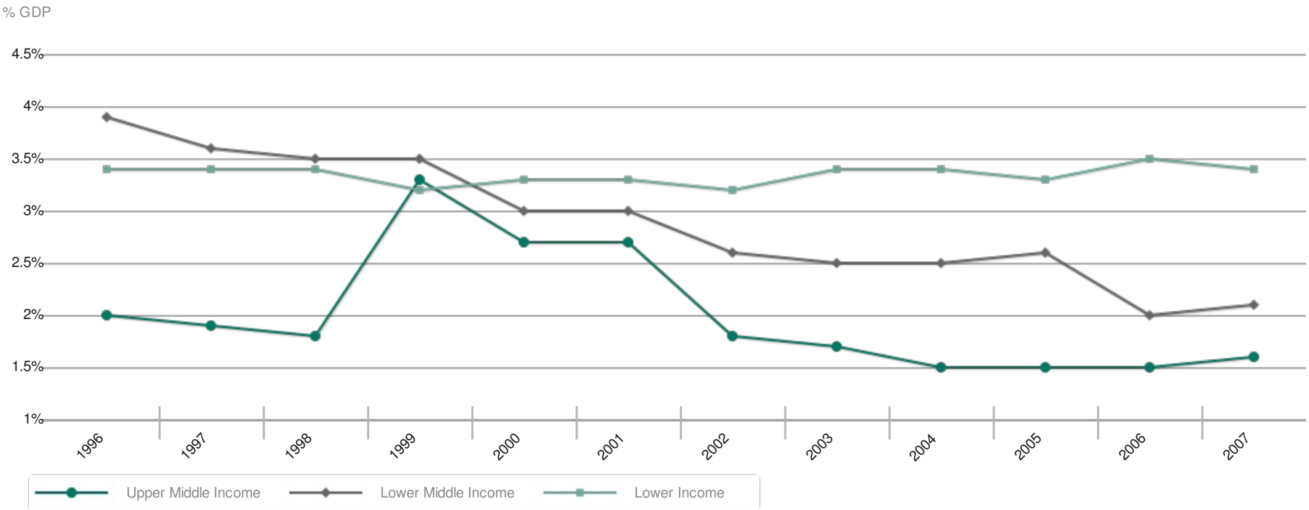
Upper-middle income countries, i.e. countries with income per capita comprised between USD 3 856 and USD 11 905 per year, are converging with OECD countries in terms of share of indirect taxes in national income. Lower income countries have done remarkably well: they have closed the gap with upper middle income countries since 1996. However, lower middle income countries still have some margin for scaling up their efforts to increase their VAT. This Outlook's country surveys report that Angola is planning to introduce a VAT in 2010, while Liberia and São Tomé and Principe are studying the desirability of introducing a VAT system.

Trade taxes in Africa

Trade taxes refer to taxes levied at the border. These are mainly import tariffs and export duties, although export duties have almost entirely disappeared. Figure 14 shows that, when countries are weighted by the size of their economy, trade tax revenues have declined by a third as a share of GDP. The decline has taken place in upper middle income and lower middle income countries, while trade tax revenue in low income countries has remained stable as a share of GDP.

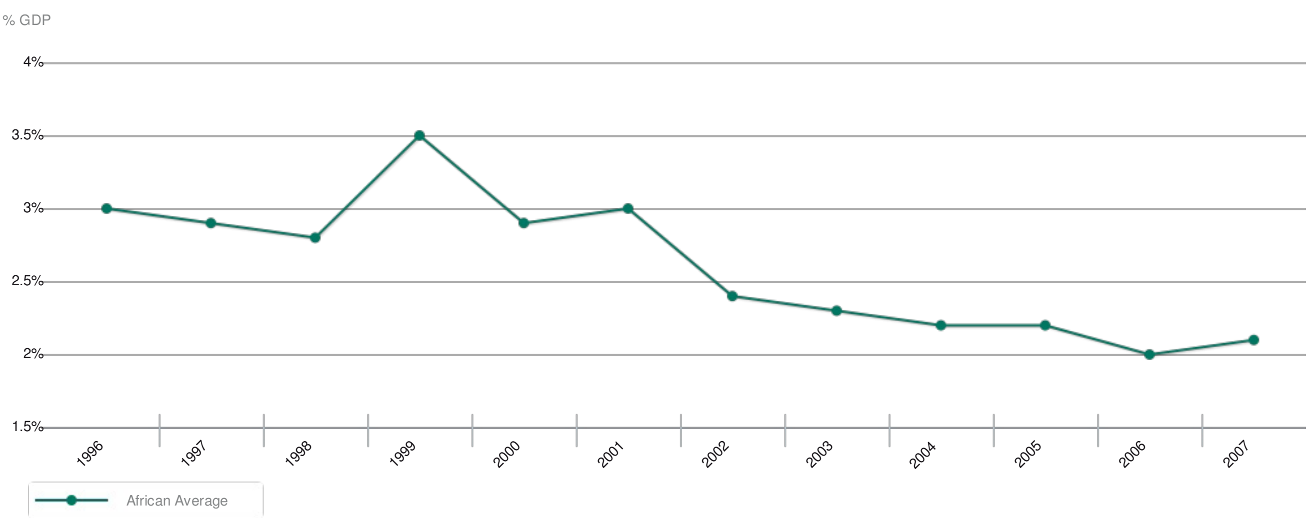
Figure 14a: Trade taxes in Africa GDP weighted - Collected trade taxes as a share of GDP



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

StatLink http://dx.doi.org/10.1787/848417480020

Figure 14b: Trade taxes in Africa GDP weighted - Collected trade taxes as a share of GDP



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

StatLink http://dx.doi.org/10.1787/848417480020

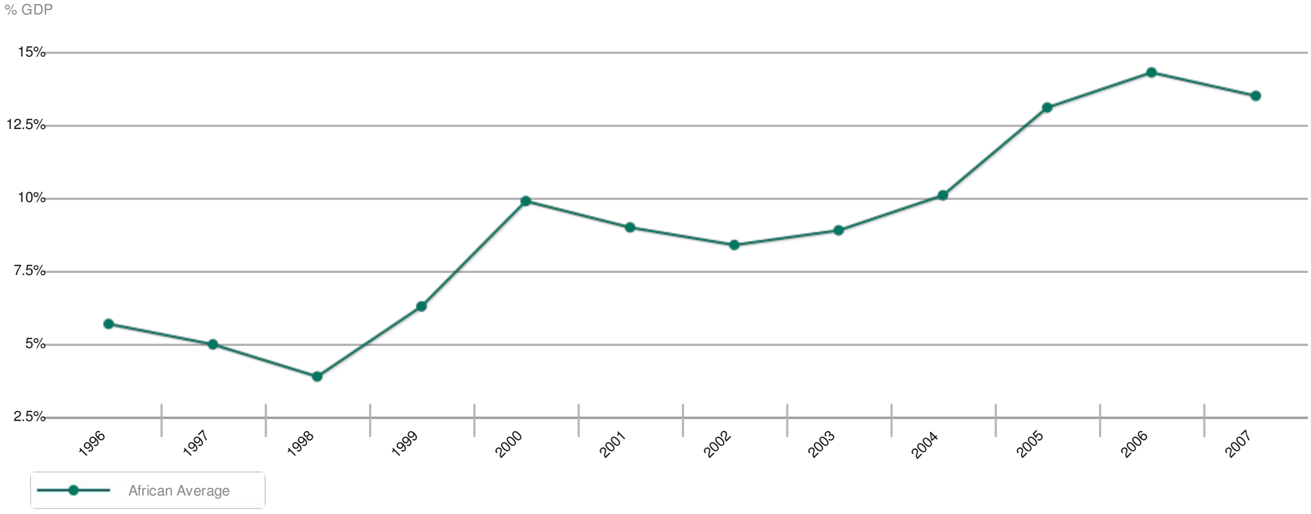
Exceptions include Botswana, the Democratic Republic of Congo, Lesotho, and Swaziland where reliance on trade taxes is the highest in the world. In 2007-08, receipts from the Southern African Customs Union (SACU) exceeded half of total revenues in Swaziland, the country most reliant on trade taxes in 2007-08. Trade taxes in Botswana make up a lower share of government revenues but that is principally due to high resource-related tax revenues. Its trade taxes as a share of government revenues still exceed the sub-Saharan African average (Keen and Mansour, 2009).

To put these observations in perspective, Keen and Mansour (*ibid.*) show that between 1980-82 and 2003-05, of the 40 countries they cover, 30 countries have lower trade taxes as a share of GDP, down on average from 7.4% to 4.2%. Only 10 countries have gained, on average from 3.2% to 4.8%. Between the early 1980s and 2005, the same authors argue that the average collected tariff rate, defined as tariff revenues divided by imports in value, has gone down in sub-Saharan Africa from above 20% to below 13%.

Resource-related tax revenues

Keen and Mansour (*ibid.*) exploited new data that, for the first time, makes the crucial distinction between regular corporate income taxes and resource-related tax revenues. The resource income includes revenues from upstream exploration-to-processing activities in oil, gas and mining, i.e. principally royalties and corporate income taxes on resource extraction activities. Figure 15 focuses on resource-related tax revenues. The surge in this type of tax revenue on the continent is striking. 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. Since, they have retreated slightly back to around 15% of GDP on average. This is still a very high percentage and this average hides some spectacular numbers in countries like 66% in Libya and 39% in Angola.

Figure 15: Resource-related tax revenues in Africa, resource-related tax revenues as a percentage of GDP



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

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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 15. It should be stressed that resource-related tax revenues may be expected to rise further. As the International Finance Corporation (2009) reported, "there is an urgent need for mineral abundant states to enter into a renegotiation of mining contracts when they are unfavourable" with the International Monetary Fund (IMF) designated as the appropriate go-between institution.

Tax effort

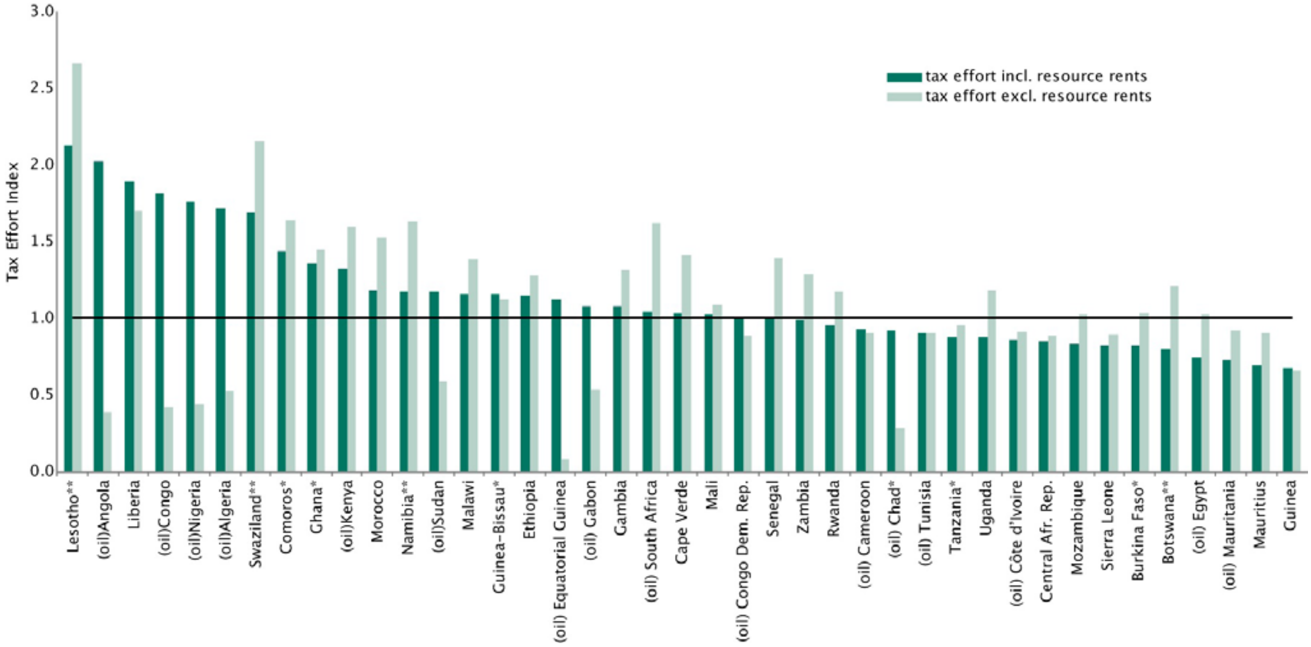
Tax effort is an index measure of how well a country is doing in terms of tax collection, relative to what could be reasonably expected given its economic potential. It is a ratio that, by construction, is always positive. Tax effort is calculated by dividing its actual tax share by an estimate of how much tax the country should be able to collect given the structural characteristics of its economy. Studies identify the general level of economic development of a country, its openness to trade and the relative importance of agriculture in domestic production, as the key characteristics bearing on a developing country's ability to collect taxes, and thus its tax share.

Empirically, these characteristics are captured respectively by per capita income, the ratio of trade to GDP, and the share of agriculture to GDP.

The tax share is expected to increase with GDP and the share of foreign trade; it decreases with the share of agriculture. Low-income, predominantly rural, land-locked countries tend to have a lower tax share than upper-middle income, coastal and significantly industrialised countries. The larger the agricultural share in an economy the lower the tax share is likely to be due to the difficulty of taxing agriculture directly and the relatively low level of monetisation in the agricultural sector (Aguirre et al., 1981). However, a large industrial sector implies a higher tax share since this sector is typically well-organised, highly monetised and relatively easy to tax in comparison to the agricultural sector (Bird et al., 2004). Comparisons based on tax effort are considered superior to those relying on tax shares because they take into account the way in which each country exploits its tax potential (Piancastelli, 2001). A high tax effort ratio, above one, indicates that the country is collecting more taxes than predicted by the structural characteristics of its economy. A low tax effort ratio, below one, indicates that the country is collecting less tax than predicted. A tax effort about one means that tax collection is as expected from structural characteristics.

Tax effort is calculated in this report for 42 African countries. The Outlook takes the position that whether or not a country is an oil producer influences its tax potential and should be taken into consideration. Therefore, two measures of tax effort have been computed. The two sets of results are illustrated in Figure 16. 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. Regardless of which set of tax effort is used, a wide range of tax effort is observed, from about 50% up to 250%-300%. In other words, some countries 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 16: Tax effort across African countries in 2007



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

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Figure 16 also shows that for some countries, the measure of tax effort is unaffected by whether resource-related tax revenues are taken into account or excluded. Ghana, Lesotho, Liberia, and Swaziland display a high tax effort regardless of the measure. Other countries like 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.

Table 1 summarises the two sets of results for countries whose tax efforts most noticeably differ from one set of estimates to the other. Estimates of tax effort for some resource-rich countries turn out to be quite sensitive to whether resource-related tax revenues are considered or not. Tax effort can be counter-intuitive when including resource-related tax revenues. It is questionable how much "effort" needs to be made to tax natural resource extraction as opposed to more politically onerous sources of taxes such as consumption, wages, and profits on ordinary types of activities.

Table 1: Tax effort including and excluding resource rents, 2007

	Tax Effort incl. Resource Rents	Tax Effort excl. Resource Rents
(oil) Angola	2.02	0.39
(oil) Congo, Rep.	1.82	0.42
(oil) Nigeria	1.76	0.44
(oil) Algeria	1.72	0.53
(oil) Equatorial Guinea	1.12	0.08
(oil) Chad*	0.92	0.28
(oil) Sudan	1.17	0.58
(oil) Gabon	1.07	0.54
Botswana	0.8	1.21
Namibia	1.17	1.63
Swaziland	1.69	2.16
(oil) South Africa	1.04	1.62

* 2006
Sources: Data for 1992-2007, estimates for 2007

Whereas the trend in tax shares in Africa is encouraging, it has mostly been driven by taxes on resource extraction activities. It may hide the fact that most African countries can further stimulate other types of taxes. Indeed, using the tax effort measure that excludes resource-related tax revenues is revealing: several countries collecting relatively modest levels of tax are actually doing quite well in terms of tax effort. This means that governments in those countries ask citizens and firms for a much higher contribution to the national tax effort than they do in most resource-rich countries. These include Burkina Faso, Ethiopia, Rwanda, Tanzania and Uganda. In sum, oil producing countries are primarily driving the remarkable quantitative rise in average tax shares across the continent, while non-oil producers have made the most progress in broadening the tax base.

Challenges for African Policy Makers

For the sake of analysis, the main tax challenges facing African countries may be grouped in three categories, although in reality many of them are interrelated. Firstly, there are key cross-cutting structural issues: the difficulty of taxing the widespread "informal economy", the limited capacity of fiscal administrations and limited support from development partners on tax matters. Secondly, there are problems with the African tax base: tax evasion and fraud, including the misuse of transfer pricing techniques, the difficulty of taxing extractive industries and overuse of tax preferences. Thirdly, there are tax mix imbalances compounded by the challenges of declining trade tax revenues and of ineffective urban property taxes.

Structural cross-cutting issues

Taxing the informal economy

The *Outlook* country surveys gather evidence that the "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. Informality is indeed widespread in developing countries, but highest in sub-Saharan Africa (Table 2). This 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 labour and social protection schemes for workers. In short, high informality leads to lower economic growth and greater social exclusion. Informality often arises where the costs of legal employment outweigh the benefits for producers, employers or employees. If entry costs into a regulated economy are unaffordable, people and businesses are forced to remain outside the system (Jütting and de Laiglesia, 2009).

Table 2: Share of informal employment in total non-agricultural employment in Africa

%, selected countries	1975-79	1980-84	1985-89	1990-94	1995-99	2000-07
North Africa					47.5	47.3
Algeria	21.8		25.6		42.7	41.3
Morocco		56.9			44.8	67.1
Tunisia	38.4	35	39.3		47.1	35
Egypt	58.7		37.3		55.2	45.9
Sub-Saharan Africa				76		
Benin				92.9		
Burkina Faso			70	77		
Chad				74.2	95.2	
Guinea		64.4		71.9	86.7	
Kenya			61.4	70.1	71.6	
Mali	63.1		78.6	90.4	94.1	81.8
Mauritania		69.4	80			
Mozambique				73.5		
Niger	62.9					
Senegal		76				
South Africa						50.6
Zaire (Dem. Rep. of Congo)		59.6				
Zambia				58.3		

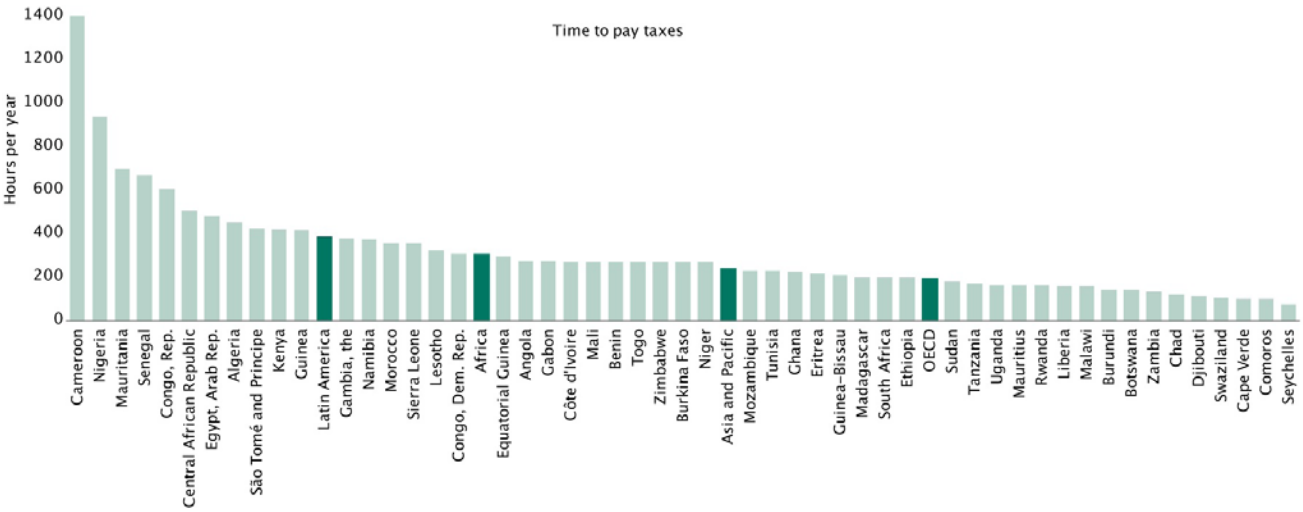
Source: Jütting and de Laiglesia (2009).

Fiscal policy in developing countries must consider capacity, incentives and segmentation. In countries where the informal sector comprises more than half of the economic activity, the question arises as to how governments can pursue fiscal policy in terms of both taxation and expenditure. On the one hand, more firms in the formal sector means increased tax collection and social security contributions for the state. On the other hand, more people covered by social security means increased liabilities for governments as employees become eligible for health insurance, pensions and other benefits where offered. In addition, the increase in tax revenue from formalising informal firms may be smaller than expected. Indeed informal firms that enter the system are often too small and too poor to make sizeable contributions. However, value-added and sales taxes could still produce a notable increase in tax collection as these also indirectly tax informal activities (*Latin American Economic Outlook*, 2009).

Ghana has tried a new approach to tax collection. The Internal Revenue Service negotiated an arrangement with the Ghana Private Road Transport Union (GPRTU) to use the union as a tax collection agent under the "Identifiable Groupings Taxation" (IGT) scheme. Simple and easy to administer, IGT calls for small and affordable taxes to be collected daily or weekly from both formal and informal union members. GPRTU retains 2.5% of revenues as an incentive to maximise collection. Although relatively successful, this attempt to make inroads into the informal sector has come at a high cost and created opportunities for corruption. So, while more tax is raised, the amount is below potential (Joshi and Ayee, 2002).

The quality of tax policies and tax administration also plays an important role. 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. While in Togo, informal firms state that complex registration procedures impede their entering the formal sector. Figure 17 plots the number of hours per year it costs businesses to pay taxes. On average, it takes fewer hours to pay taxes in Africa than in Latin America, but more than in the Pacific, Asia and OECD countries. However, on the left hand of the scale are countries where the compliance burden is exceptionally high. See OECD-CTPA (2008) for an extensive discussion of the tax compliance burden.

Figure 17: Time needed each year to pay taxes



Source: PricewaterhouseCoopers- World Bank, *Paying Taxes* (2009).

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Tax administration capacity

Administrative capacity constraints have been highlighted throughout the Outlook country surveys as a major obstacle to improving tax policy in Africa. The administrative constraints are such that they limit policy options.

- For example, in theory, relying more on income tax and exemptions on basic consumer items would enable more redistribution of resources. But where administrative capacity is weak, personal income tax is less progressive than expected. Firstly, only wages, mostly earned in large private firms and in the public sector, are taxed. Secondly, personal income earned on capital is typically not taxed. Capital, real estate income and other revenues of high earners in the informal sector are thus outside the reach of tax administration.
- For a variety of reasons, VAT exemptions in Africa are often regarded by experts to be regressive (Box 1). Strategies that copy those used in countries with high administrative capacity can be counter-productive. In Morocco, before a 2005 fiscal reform, generous VAT exemptions undermined the potential of VAT introduced in 1986.

The vast majority of countries in the *Outlook* survey cite the lack of skilled staff as a major impediment to tax collection. The constraining factors encourage corruption, as highlighted in the country notes of Cameroon, Comoros, Guinea-Bissau and Nigeria.

The surveys have shown that despite great progress in adopting Information and Communication Technology to increase revenue collection, more can still be done. South Africa offers e-filing for payroll taxes, while Botswana, Cape Verde and Cameroon have e-taxation platforms. These initiatives require educational campaigns to motivate individuals and enterprises to use these systems. In Cape Verde, about 15% of companies used the new e-taxation system in 2009. Algeria, Angola, Côte d'Ivoire and other countries are looking for ways to incorporate new technology in their taxation systems.

Box 1: Regressive nature of VAT exemptions for commodities in Africa

Paradoxically, "traditional" VAT exemptions on commodities (Chambas, 2005) compromise poverty-reduction strategies. We immediately think of the reduction in tax revenue and the resulting fall in the financing of public spending as a result of tax exemptions. But we generally forget another direct effect of VAT exemptions.

In an open economy, the price levels of tradable goods are a result of CIF (cost, insurance and freight) prices, including taxes. If there are VAT exemptions on commodities, the prices of commodities, especially food products, are lower than if they were subject to VAT, since the exemption means that VAT is not applied at the border. This decline in domestic prices affects not only exempted products, but also substitute products. A VAT exemption for rice, for instance, could reduce the price paid to local producers, and even to producers of substitute products for rice. Indeed, the effects of a VAT reduction generally fall not on the marketing and processing channels but on the producers, who are paid lower prices.

Consequently, exemptions lead to a fall in the price of commodities -- usually food products -- thus benefiting consumers, especially poor people in urban areas. But the lower prices of products have a negative effect on local agricultural production, reducing producer prices and therefore the revenue of local producers, especially farmers, many of whom are also poor.

Furthermore, the more modern producers of agricultural products are worst affected in terms of competitiveness, since the significant input supplies they require are subject to VAT. As a result of the exemptions, even if local producers choose to be subject to VAT in order to benefit from the rebate mechanism, they must definitively bear the VAT on their intermediate consumption subject to VAT. The disadvantage of residual VAT places producers in a situation in which they have negative protection against imports not subject to any VAT (the VAT exemption applies at the customs barrier).

VAT exemptions are therefore counter-productive to the aim of reducing the poverty of the poorest agricultural producers and they slow down the development and modernisation of the agricultural sector.

Source: Jean-François Brun and Gérard Chambas, CERDI.

Getting donors to help

Whether, overall, aid helps or hinders public resource mobilisation remains unclear. However, it is a well established fact that the share of aid aiming to strengthen it is still very small.

There is increasingly widespread concern that the availability of foreign aid may reduce incentives for governments to raise domestic revenue. This may, in turn, negatively affect the quality of governance by reducing pressure for state capacity development and reducing incentives for government to bargain with citizens over taxes, as discussed earlier. Obviously, tax administrations are genuine in their desire to raise revenue, but the availability of large foreign aid flows may reduce the urgency with which revenue collection is pursued. There is an additional risk that aid-dependent governments, in particular, will shy away from politically demanding income, property and local tax reforms, while these are precisely the areas that are likely to be most important to tax-governance linkages. In practice, however, it is very difficult to test the impact of aid on domestic revenue because of the many factors that shape tax collection. The debate amongst academics remains largely inconclusive (Box 2). Eventually, aid donors are an integral part of the political economy of public resource mobilisation, even more so as they increasingly propose financial and technical assistance to increase revenue collection.

Indeed, ODA often includes components designed to increase revenue collection, such as direct funding for tax reform; conditionality that requires increased or at least constant, domestic revenue generation; requirements for local matching funds for aid projects; and/or demands for increased social spending which, indirectly, generate pressure for greater revenue mobilization. Figure 18 shows that public sector financial management represented 2% of aid spent on technical cooperation in Africa in 2008. Given that tax administration is a subset of technical cooperation for public sector financial management, donors' help in building African tax administrations is less than 2%. The Outlook country surveys confirm that there is a lot of room to increase aid in this area. Finally, the issue of whether aid-funded goods and services should be taxed by recipient governments is discussed in the next section.

Box 2: Does aid help? A review of the academic debate

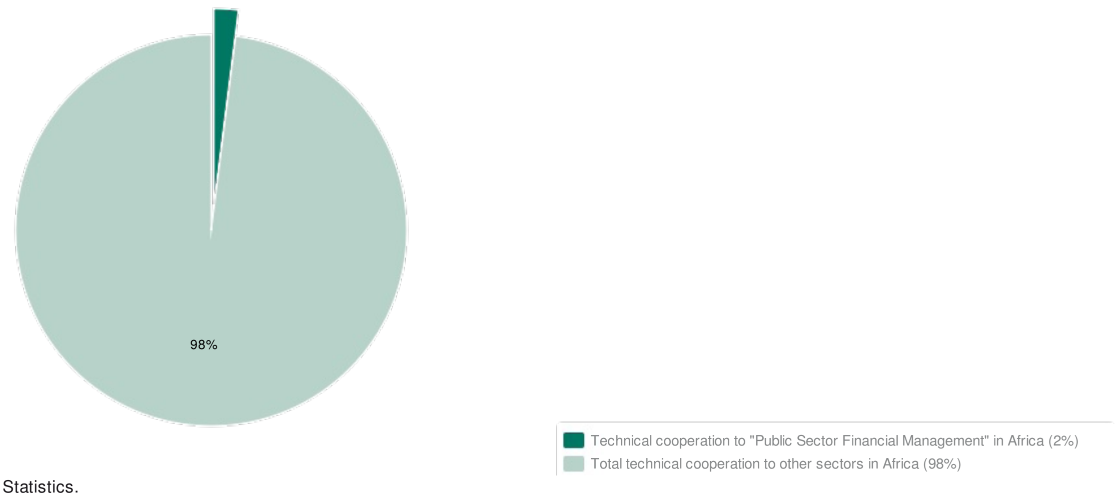
The renewed interest for public resource mobilisation in Africa comes at a time when the effectiveness of foreign aid on the continent is again being questioned. Against the "aid fatigue" argument, proponents of aid have been saying that the returns from aid-funded investment in development can be enormous. They argue that a "big push" in aid funds is required to turn a vicious circle of poverty and under-development into a virtuous circle of poverty reduction and shared economic prosperity.This "big push", first popularised in the 1950s and 1960s (Easterly, 2005; Guillaumont and Jeanneney, 2006), is now advocated by the UN under the lead of academic Jeffrey Sachs. Aid considered as a "subsidy" provides temporary financial assistance to encourage long term revenue collection, investment in physical and human capital, and the establishment of the institutions of a developmental state (Brautigam and Knack, 2004). Aid-as-subsidy played this role in Botswana, South Korea or Chinese Taipei (Brautigam, 2000, Moss *et al*., 2006).

Conversely, Ross (2004) makes the case that, like resource rents, foreign aid hurts incentives for good governance in Africa and elsewhere. The so-called "resource curse" argues that unearned income undermines incentives to build local institutions and a social contract with the population. Aid is suspected to have a similar effect of discouraging revenue collection, distorting expenditure decision-making and undermining the incentives to build state capacity. Under this view, aid is not only a crutch delaying institutional development, but potentially undercuts those effects (Moss *et al.* 2006,). When a government specifies expenditure needs and donors match these needs with budget support, the public budget constraints are softened and so there is no incentive to raise revenues. Aid would also lead to overall increases in government spending (Remmer, 2004). As politicians have less of a need to prioritise expenditure within a budget constrained by revenue collection, it would weaken government's capacity to identify budgetary trade-offs. In addition, as Heller and Gupta (2002) argue, the fiscal uncertainty of dependence on external assistance makes long-term planning extremely difficult for countries.

Collier (2006), however, argues that aid has "a less damaging effect on governance than oil if it is provided in "purposive" ways, and accompanied by mechanisms of scrutiny, expertise and management techniques that can add value, and create some pressure for accountability". Besides, the "resource curse" thesis, applied to either natural resource rents or aid flows, finds little robust evidence in the academic literature.

Amongst the studies that focus more specifically on the impact of foreign aid on tax revenue and tax administration, several conclude that this impact is negative (Remmer, 2004; Gupta , 2005; Devarajan, Rajkumar and Swaroop, 1999; Brautigam and Knack, *ibid*.; Knack, 2009). Gupta (2007), however, finds a negligible, or even positive, impact of aid on tax revenue. As for studies by Brun (2007) and Cottet and Amprou (2006), they do not clarify whether aid helps or hinders domestic resource mobilisation. Much depends on the type of aid flow and the circumstances in the recipient country. In their 2004 study, Gupta *et al*., focus on the revenue response to foreign aid, separating total net aid into grants and loans to test whether the impact of grants on domestic revenue is different from that of (concessional) loans. The study suggests that some governments may consider grants to be free substitutes for tax revenue. By contrast, loans must be repaid, which provides incentives for governments to at least maintain tax revenues at current levels if not to increase them (Brautigam, *ibid*.). Finally, aid is thought to work best in states with high quality public institutions (Burnside, Craig and Dollar, 2000; Brautigam, *ibid*.).

Figure 18: Public sector financial management as a share of technical cooperation to Africa in 2008



Source: OECD DAC Aid Statistics.

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Tax base issues

Multinationals and misused transfer pricing techniques

Multinational enterprises (MNEs) are responsible for more than 60% of world trade and roughly half of this exchange of goods and services takes place within individual conglomerates (UNCTAD, 1999). International trade is thus largely an activity between different divisions of the same enterprise operating in different jurisdictions. MNEs may take advantage of the different tax regimes, including tax havens to maximise after-tax profits. One way in which multinational enterprises may try to benefit from their international presence is misuse of transfer pricing, *e.g.* by artificially shifting taxable profits from high tax jurisdictions to low tax jurisdictions. This happens when firms under- or over-invoice for goods, services, intangibles or financial transactions between entities situated in different tax jurisdictions.

African tax authorities may not be able to identify such profit shifting where this occurs and even if they did, they often lack the means and technical capacity to deal with the complexities of the practice. Despite the development of international and domestic guidance, even the world's most sophisticated tax administrations sometimes have difficulties assessing whether the prices at which multinationals carry out cross-border transactions are manipulated, especially for complex financial transactions and those involving significant unique intangibles. African tax administrations already struggle to collect regular corporate tax beyond a few dozen of the largest companies. Auditing capacity is often very limited and relies mainly on information directly provided by the multinationals. Not to mention that the dispute resolution process in any disagreement with a trans-national enterprise can be very costly.

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, a number of studies have tried to approximate its magnitude. Kar and Cartwright-Smith (2008) estimate that total trade mispricing in 2006 was more than USD 500 billion. Hollingshead (2010) reckons that the amount of tax revenue lost by developing countries to misuse of transfer pricing averaged between USD 98 billion and USD 106 billion annually from 2002 to 2006. In Africa, a yearly average of USD 3.8 billion would have been lost between 2002 and 2006. Again, these figures must be treated with some caution since they are based on models for assessing the loss of tax revenues which are still being developed.

Taxing natural resources

Vast extractable natural resources – oil, gas and minerals – are already an essential revenue source for many African nations. But the African Development Bank's 2007 *African Development Report* highlighted the widely held belief that African countries get less money from resources than many other countries in the world. There is evidence that African countries are not maximizing the tax revenue they obtain for the resources (Keen and Mansour, *id.*). 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. There is little transparency and disclosure. Corruption is often blamed for this secrecy. Corruption and secrecy feed off each other. But there is more than corruption involved. Governments argue that they cannot make all details of the extractive industries public and that they have limited influence on companies. Countries compete for the scarce managerial and technical skills needed for resource extraction (Di John, *ibid*.). Yet, shortages of legal and negotiation skills play a major role in driving down tax revenues from natural resources.

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. In Sudan, for instance, a high proportion of civil servants are exempt from paying taxes, undermining the country's tax base.

Tax preferences are difficult to target and may not yield intended outcomes. Significant tax revenue losses and other unforeseen effects may result instead. Inefficiencies and inequities can also arise where tax relief is targeted to specific groups over others for political reasons. Indeed, tax preferences can undermine the tax base, revenues, and fiscal legitimacy when granted arbitrarily. For example, tax preferences granted to powerful and rich potential tax payers place more of the tax burden on people with less economic and political clout. African governments also lose a significant amount of revenue from corporate income tax exemptions, though the cost is hard to estimate given their often arbitrary nature (Keen and Mansour, *id.*). Yet corporate income tax and other tax revenues are essential for funding infrastructure, education, and expenditures underpinning good governance, which investors repeatedly identify as key considerations when making investment location decisions. Finally, the consequences of exemptions granted to aid-funded goods, services and personnel are also debated by donors and recipients (Box 3).

Countries should therefore use tax incentives with care. This includes explaining the rationale for their use and reporting tax revenues foregone by tax incentives (tax expenditure reporting) for transparency and the integrity of the tax system, while at the same time guarding against erosion of the tax base needed to fund economic development.

Box 3: Taxation of aid-funded goods, services and personnel

Donors frequently secure tax exemptions from developing countries on aid inputs. The exemptions typically include income taxes on aid worker salaries, goods and services; value-added taxes on local purchases; and customs duties and excise taxes on imports. Tax officials in recipient countries consider that such exemptions weaken their tax systems, generate considerable costs and complications and provide opportunities for corruption. Some multilateral donors have already taken action on this issue. The World Bank typically rolls the relevant duties into the total loan (and later debt), allowing them to be met from within the loan amount. This is implemented in different ways, often by setting a government project 'share' or matching payment at the assumed minimum level of taxes.

This is an issue of both principle and practice for developing country tax systems. In principle, exemptions should be removed for reasons of economic efficiency and consistency and to help strengthen tax systems. In practice, it is argued that the exemptions:

(i) cause economic distortions (goods and services imported from donor countries may receive preferential tax treatment over domestically-produced goods and services);

(ii) provide opportunities for corruption, particularly tax fraud and tax avoidance schemes, both of which have to be policed by tax administrations, straining their scarce resources;

(iii) importantly, fuel a tax exemption culture which affects overall governance; while taxing government activity obviously generates net public resources, perceptions matter and public servants not paying taxes discourages other tax payers from carrying out their fiscal duty; and

(iv) impose significant transaction costs because of the large number of individually negotiated agreements with each donor country.

Country-level evidence suggests that tax exemptions for aid-assisted projects represent a significant budgetary issue for recipient countries. In Niger, tax expenditures on vouchers—one method by which exemptions may be implemented—amounted in 2002 to about 18% of project financing, and 10% of all tax revenue. In Tanzania, customs exemptions for donors accounted for around 17% of the gross value of imports in 2005. Developing countries argue that removing exemptions would widen the tax base, boost the credibility of both the revenue administration and the donors, simplify tax systems and encourage voluntary compliance by local and multinational taxpayers.

From a donor perspective, the process of unravelling the current range of exemptions would be complex and the benefits uncertain. Very few bilateral donors have indicated an interest in debating this topic. Donors are unlikely to accept that developing countries forgo revenue by accepting aid from outside, and would point out that paying taxes on aid inputs reduces the resources available for other projects. There is also scepticism as to whether removing exemptions on aid inputs would lead to a general abolition of exemptions, including on developing countries' own purchases.

Source: OECD-DAC (2010).

The imbalances

A balanced mix of taxes can help stabilise 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. A heavy reliance on corporate income taxes also leads to tax revenue volatility, this time through the correlation of the tax base with the business cycle. VAT can also be business-cycle sensitive.

Each tax is influenced by a different factor. By balancing the different types of tax, a country is able to lower the overall volatility of tax revenues. Diversifying the fiscal base stabilises revenues and brings political benefits. Stakeholders who make up a large part of the tax base will naturally tend to be given more attention by policy-makers than those who barely contribute to revenues. Diversifying the tax base broadens a government's natural constituency, increases local ownership of the development agenda and enhances democratic governance. Senegal, Tanzania and Cape Verde stand out as having made a lot of progress on diversifying their tax mix over the past decade.

Declining revenue from trade taxes

As discussed in Chapter 2, trade-related tax revenues have been decreasing over the last decade in Africa in the face of trade liberalisation. 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.

Although trade liberalisation is on the political road map of most African regional blocks, its implementation remains extremely fragmented. Trade liberalisation affects tax revenues in two ways, direct and indirect. The direct effect is that, in the short run, trade liberalisation — tariff cuts — provokes an immediate fall of tariff revenue. Longoni (2009) finds evidence of a large trade-off between greater openness to international trade and the revenue collected from trade taxes.

In the longer run there is an indirect effect when trade liberalisation triggers a process of increased domestic competition and higher investment incentives that leads to higher economic growth. Other tax revenues may rise or fall, depending on the impact of trade reform on growth. Baunsgaard and Keen (2005) estimated that revenue recovery from the suppression of trade taxes in low-income countries (those most dependent on trade tax revenues) is not more than about 30 cents of each lost dollar. The net impact of trade liberalisation in the short run is thus a net tax revenue loss.

Ineffective urban property taxes

Rural land reform is a largely unresolved question in most parts of Africa. However, urban property taxes offer a significant, and largely unexploited, opportunity for taxation. There are as many urban inhabitants in Africa as there are in North America. 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. The Outlook surveys show that a large number of countries apply some sort of urban property tax, however they vary greatly. Egypt, for example, plans a property tax on farmland. The general observation is that, due to political sensitivities and outdated or incomplete cadastres, property taxes do not yield as much revenue as they should.

Policy Options

A number of policy options are discussed in this section. The order in which these policy options are presented 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, boost administrative capacity and harness international cooperation to improving resource mobilisation. The longer-term goal of generating revenues from a more balanced tax mix could be achieved with more focus on instruments such as urban property taxes. It is a progressive tax which can be scaled up to keep pace with Africa's explosive pace of urbanisation and the corresponding need for urban infrastructure. Development partners can easily help with such a tax.

Ideally, what can African countries do to improve their tax systems?

Recent studies have made several recommendations to African policy makers about tax treatment. Volkerink (2009), IFC (2009), Keen and Mansour (*id.*), Bahl and Bird (2008) said taxes should be levied at low and relatively flat rates across a broad base, as they are easier to collect and administer. As well, exemptions and loopholes should be eliminated. Countries must move away from heavy reliance on inefficient trade taxes. VAT must become the focus of indirect taxation, replacing turnover and even sales taxes. The basic message is keep tax low, flat, simple and broad based.

The most effective way of increasing public revenue is through policies that increase the tax-base through sustained economic growth. Efficient tax collection also strengthens public resource mobilisation without over-taxing the economy. Any increases in taxation should ideally be growth-neutral, without harming the already weak private sector in many African countries.

To increase revenues, a country can increase taxation on current payers, and/or increase the number of potential payers. African countries should target new potential tax payers over time. A wide tax base is more stable because it relies on a diversified set of taxes, with a mild burden on each type of taxpayer and each type of economic activity. A wide base engages a bigger range of stakeholders in the national political process.

But tax policy needs to walk the tight rope of tax administration constraints

Governments should first identify which tax options are feasible and then maximize revenue within these options. Short-term tax policy options in most African countries are constrained by the tax administration capacity. Stakeholders often over-estimate what can be reasonably achieved through tax policy. In particular, there are fewer redistributive tax policies available than in industrialised countries. Therefore, upgrading tax administration is a pre-requisite to reducing income inequality through progressive taxation.

Copying redistributive strategies used in countries with high administrative capacity can be very counter-productive, either unintentionally or because such strategies benefit the middle-class. It would be better to raise fees on tertiary education, introduce road tolls, car registration fees – all key consumption items for richer Africans. These are likely to be politically difficult to introduce as they are aimed at the elite who have most influence on legislation. Bolnick and Haughton (1998) suggest that African countries could use excise taxes more intensively, despite the fact that these are levied at high rates on a narrow base. Property-based taxes may also provide options for income redistribution. Here too, the elite that are most likely to pay the tax can discourage the legislation.

Deepening the tax base

The tax base is the set of economic activities and assets that is taxed. Broadening the tax base by widening the payer net does not necessarily mean more revenues will be collected as the cost of collection must be considered. Any attempt to broaden the tax net needs to take into account whether the extra revenues outweigh the collection costs. The priority targets should be those benefiting from tax preferences, those misusing transfer pricing to shift profits, and the extractive industry. Many countries have successfully enlarged their tax bases. Tunisia's has increased its own at a yearly average of 3.5%, South Africa has more than doubled it, as has Egypt in the last five years, while Côte d'Ivoire has rebuilt its tax base after civil war.

Figure 19 shows where African countries stand in terms of tax base diversification. There is an impressive amount of diversity across African countries with respect to the composition of their tax bases. To extract useful patterns, a typology of six types of countries has been developed. The goal is to distinguish between the quantity of taxes and the political quality of the tax base. In the top row are countries with tax shares above potential, the bottom row features countries with tax shares below potential. Columns classify countries directly according to their tax shares, *i.e.* collected taxes as a share of GDP, with the first column corresponding to countries with a share smaller or equal to 15% of GDP, the second column, countries with a share of 15%-20% and the third column to those with a tax share above 20%.

Countries with a tax share above what would be expected on the basis of their fundamental characteristics are those that collect few taxes on resource rents. Conversely, countries with a tax share below what would be expected are those that rely heavily on resource rents. Countries rich in natural resources can afford to – and tend to – shy away from more politically demanding forms of taxation. Their fiscal revenues are more exposed to volatile commodity prices, making macroeconomic management and development planning more difficult. Further, the disproportionate importance of resource taxes implies that stakeholders outside the resource extraction sector are insufficiently represented in the tax base, raising concerns about the political representation of a large part of society in these countries.

Another pattern that emerges is that fragile countries – which extreme poverty puts at risk of conflict or disease epidemics – tend to have low tax shares and tax efforts. More stable countries tend to have higher tax effort and tax shares. Some caution is needed in the case of fragile countries. Typically, trade tariffs play an important role in their tax mix while direct taxes play a small role. History shows, however, that public resource mobilisation has played an important role in post-conflict countries (Box 4). They need to make a gradual and careful move away from trade taxes, which can only be ended as VAT and other types of tax are phased in (Di John, *id.*).

Countries also have to be careful how they increase the share of taxes in national income, especially those with an already high tax effort. Merely increasing tax rates is rarely the solution. It is often better to lower tax rates while eliminating exemptions and expanding the tax base to new payers. There is a limit, though, to the amount of taxes even the most effective administration can collect. For countries with a high tax rate, the main road to enhancing the fiscal share is to widen the tax base by pursuing private sector development. Efficient, effective and fair taxation is a crucial condition for development but fiscal reform is not a substitute for an effective development agenda but it should be a priority.

Box 4: Tax administration/reform in the context of post war-conflict countries and fragile states

About half of the countries of sub-Saharan Africa can be categorised as fragile states. [3] With some exceptions (mainly oil producers), tax revenues in fragile states are typically less than 20% of GDP, reflecting the low levels of formalisation of the economy and weaknesses in tax administration. Key objectives of tax reform in fragile states are to boost budget revenues to fund a rebuilding of public services, to support sustainable economic growth and to contribute to better governance.

Most fragile states have a relatively narrow tax base. Broadening the tax base requires stronger tax administration. Hence alongside tax policy reforms, institutional reforms have also been implemented with financial and technical support from development partners such as the UK Department for International Development (DfID), the World Bank and the IMF. Tax administration reform aims to create a modern system based on voluntary compliance by taxpayers, backed by risk-based selective audits to enforce compliance. Especially in fragile states where technical capacities in both the public and private sectors are weak, this requires the creation of tax systems which are relatively simple, easy for taxpayers to understand and transparent, and where payment procedures for taxpayers are simplified.

A key component of tax reform has been the reorganization of tax administration along functional lines, rather than by the type of tax. This includes setting up large taxpayer departments to handle the companies which often generate up to 70% of domestic tax revenue. Furthermore, 14 sub-Saharan African countries, about half of which are fragile or post-conflict states, have established semi-autonomous revenue agencies to take over tax collection - but not tax policy - from government ministries. The rationale for revenue agencies is that, compared with the civil service, they can pay more competitive salaries and have more managerial autonomy and clearer incentives for collecting revenue.

The achievements of tax reform in fragile states, in terms of raising revenue, have been mixed. In some post-conflict countries where revenue had collapsed, such as the Democratic Republic of Congo, Mozambique, Uganda, Liberia and Rwanda, tax reforms have facilitated a recovery in revenue. Sustaining further increases in the revenue/GDP ratio, on the other hand, has proved more difficult.

Key lessons of tax reform in fragile states include:

(i) political commitment for reform is imperative because raising revenue requires bringing politically influential taxpayers fully into the tax net, for example by removing tax exemptions. Tax incentives have actually become more ubiquitous in SSA since the 1990s and this has weakened the tax effort;

(ii) the authority to make all decisions on tax policy must be centralised in the Ministry of Finance. Agencies which have no responsibility for public finance, such as Investment Agencies, should not have the authority to confer fiscal concessions on taxpayers;

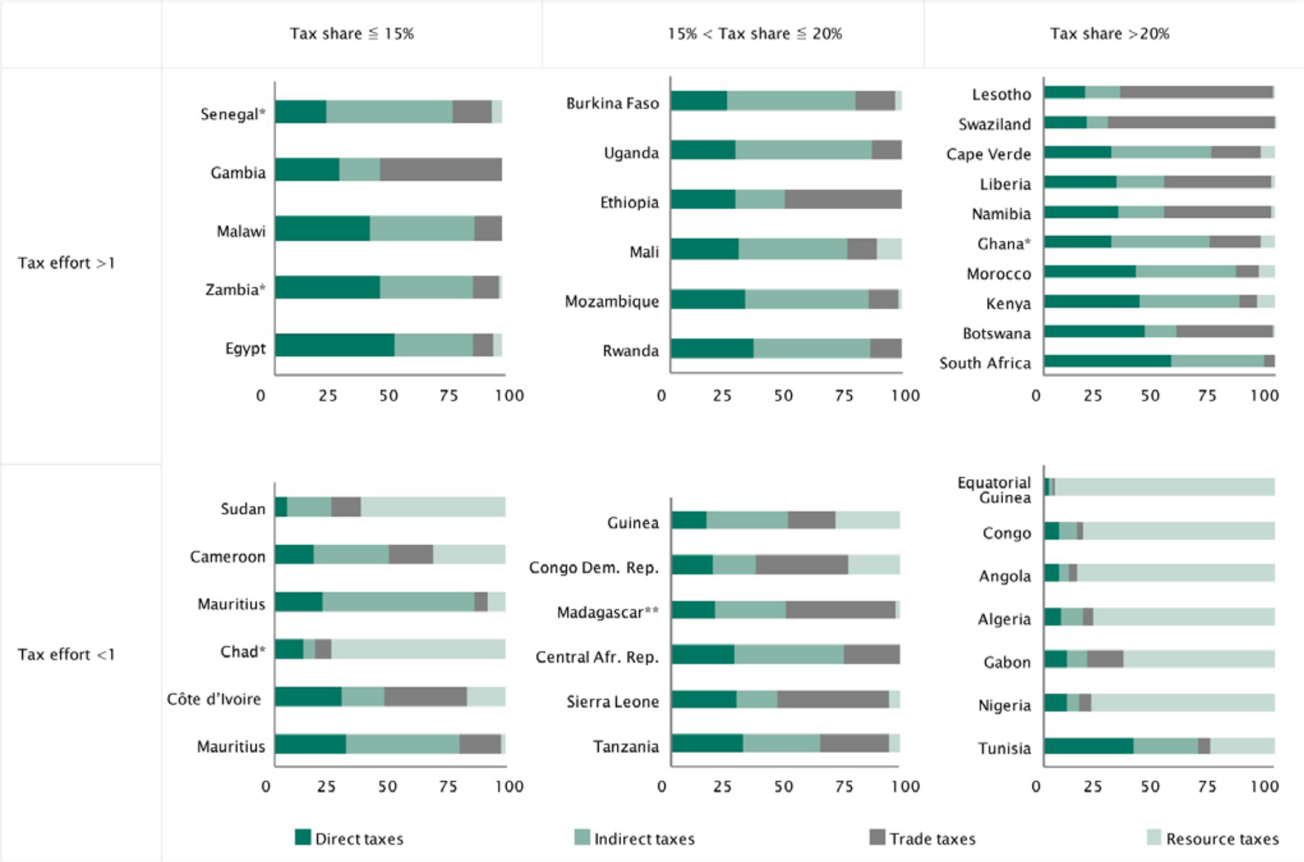
(iii) it is counterproductive to try to enforce complex taxes such as VAT or income tax on small and micro enterprises because the costs of collection outweigh the benefits; these enterprises will pay VAT when they purchase inputs from the formal sector;

(iv) reforms to tax administration should be part of a broader effort to strengthen governance and public financial management; and

(v) opportunities for corruption are pervasive in tax collection; hence a comprehensive anti-corruption strategy, including an effective internal audit function, is essential.

Source: Martin Brownbridge, Oxford University.

Figure 19: Tax effort vs. tax shares, a typology of African tax systems



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

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Ending tax preferences

Whether tax incentives are a cost-effective way of overcoming impediments to investment depends on the host country's investment conditions and characteristics. In general, it is better to focus on the actual impediments to investment and aim to address these directly. Addressing non-tax impediments may be a more effective policy to attract investment than seeking to match the tax incentives provided by other countries, especially if the latter prompts a race to the bottom as countries compete for investment and no country collects much tax as a result.

As case studies show, key investment considerations include market size, political and economic stability, rule of law and protection of property rights. Where tax is identified as a major issue, transparency and stability of the tax law, administrative certainty, and a wide tax treaty network are typically ranked well ahead of targeted tax preferences. Uncertainty over the tax treatment of FDI increases the perception of risk and discourages long-term, capital-intensive investments that governments are typically eager to attract. Administrative discretion in granting tax incentives undermines transparency, and creates a perception that the tax authorities are open to influence and persuasion. Where tax systems are seen as unfair or open to negotiation, this risks eroding voluntary compliance with the system.

In providing an attractive tax system for investors, African governments should aim for transparency and certainty of tax treatment, and take steps to limit compliance costs (e.g. through taxpayer education, streamlined payments), before exempting international investors from all or part of their fiscal obligations. Simplifying tax legislation, establishing "Large Business Offices" to improve service to important clients, and initiating electronic payment facilities are all important steps that African nations have used to improve compliance. Businesses are often willing to trade higher tax payments against lower compliance costs and more predictability and transparency in the assessment of their liabilities. Egypt is a good example. The Outlook country surveys confirm the progress made by countries that have established large business offices, including Algeria, Angola, Cameroon, Central African Republic, Côte d'Ivoire, Egypt, the Gambia, Niger, South Africa, Sudan, Uganda and Zambia.

Revenues foregone by tax incentives for investment – such as tax holidays, partial profit exemptions, free trade zones, etc. – tend to exceed by a wide margin the revenue costs expected before the concession is put in place. In particular, countries frequently underestimate tax planning opportunities for multinationals to extend the coverage of tax relief to shelter non-targeted activities and profits. Increased reliance on other taxes and the need for tax base protection measures place additional strains on the tax system.

At the same time, competition amongst countries to attract mobile investment creates pressure for continued use of targeted tax incentives. Given this, some degree of cooperation amongst countries may be necessary to prevent a counter-productive race to the bottom in effective tax rates on profit, especially amongst those countries linked by free trade arrangements and thus likely to be in the most direct competition for mobile capital. Arguably, with some form of regional collaboration, the priority of policy makers should be to limit the most damaging tax preferences such as tax holidays and export incentives. A monitoring framework and system to exchange information would be necessary to implement this type of agreement (IMF, 2009).

The African Tax Administration Forum (ATAF, see Box 5), which was officially launched in 2009, could act, if properly mandated, as the political and logistical platform to implement such an agreement and to establish best practices for the reporting of fiscal expenditure. Even without international collaboration, policy options are available at the national level. Morocco and Egypt, for example, have both shown that eliminating exemptions while lowering tax rates can increase overall fiscal revenue. This type of reform is beneficial from a taxation and investment perspective: it boosts tax revenues and the transparency and predictability of the investment environment. Angola, Cameroon, Central African Republic, Côte d'Ivoire, São Tomé and Principe, Senegal and Togo are all pursuing similar reforms. As a prelude to such reforms, tax expenditure analysis and reporting can be useful in stimulating discussion among stakeholders.

Box 5: The African Tax Administration Forum (ATAF), the African Development Bank (AfDB) and related initiatives

The African Tax Administration Forum (ATAF), officially launched in November 2009 in Kampala, Uganda, brings together the heads of African tax administrations* to discuss common challenges and key priorities for effective domestic resource mobilisation. ATAF's objective is to become a platform for articulating African tax priorities and building the institutional capacity of the continent's fiscal administrations through peer learning and the sharing of good practices. It is setting up an African Tax Centre to foster experience-sharing, benchmarking, and peer reviewing. ATAF is engaged in regional and international dialogue on taxation.

The African Development Bank (AfDB) is a strategic partner of ATAF since its inception, providing both financial and technical support. Together with ATAF and the Korean African Economic Cooperation Fund, the Bank has established the East Africa Tax Initiative, which focuses on sharing best practices in revenue governance in East Africa (Burundi, Kenya, Rwanda, Tanzania, and Uganda). The AfDB also facilitates deeper dialogue with other pan-African platforms that deal with different aspects of public finances, such as the Collaborative Africa Budget Reform Initiative (CABRI) and the African Organization of Supreme Audit Institutions (AFROSAI).

**ATAF members as of March 1st, 2010: Botswana, Chad, Egypt, Eritrea, Gabon, Gambia, Ghana, Kenya, Lesotho, Liberia, Malawi, Mauritania, Mauritius, Morocco, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, South Africa, Sudan, Uganda, Zambia and Zimbabwe.*

Source: CABRI & AfDB (2008).

Finally, removing tax exemptions on aid-funded goods, services and personnel could render aid more conducive to effective domestic resource mobilisation not only by generating new fiscal revenues, but also by sending a signal that all economic activity should be subject to taxation (Box 3). The issue of tax exemptions for international assistance projects has been on the agenda of the United

Nations Committee of Experts on International Cooperation in Tax Matters for the last few years. In 2006, the Committee discussed draft guidelines prepared by the secretariats of member organisations of the International Tax Dialogue (ITD). However, the UN Committee comprises only tax experts from developed and developing countries. The UN Committee has acknowledged the debate will not advance without the donor agency staff who include the exemptions in memoranda of understanding governing aid contributions. The debate has been given new impetus by the Africa Tax Administration Forum which wishes to engage donors on this topic. African countries should actively engage in these discussions and adopt a common stand.

Dealing with transfer pricing

Even the most sophisticated tax administrations struggle with transfer pricing. There are different approaches to tackling the problem. The most commonly adopted approach is the Arm's Length Principle. All OECD countries use this principle, as well as non-OECD countries such as Argentina, China, India, Russia, Singapore and South Africa.

According to the Arm's Length Principle, the conditions of cross-border transactions between different parts of a multinational enterprise should not differ from those which would be agreed between independent firms, *i.e.* they should not be distorted by the control relationship that exists between them (Box 6). This principle aims at achieving a dual objective: protecting a country's tax base against artificial shifting of profits abroad by multinational enterprises, while at the same time limiting the risks of disputes and of economic double taxation that can arise if two countries take differing views as to what the "fair" price of a transaction should be. Under the Arm's Length Principle, the conditions of commercial or financial transactions between different parts of a multinational enterprise should not differ from those which would be made between independent enterprises in comparable circumstances. In effect, economic double taxation can arise if the same amount of profit is being taxed in two different jurisdictions which take differing views about how to determine "fair" prices.

While the Arm's Length Principle is simple, its implementation can be complex. Governments need a solid legislative framework and tax administrations to develop the expertise and build the resources to enforce transfer pricing legislation. This can only be done over time, as many OECD countries have experienced and continue to do. This means that risk assessment techniques are needed to focus the enforcement of transfer pricing rules to the riskier areas of cross-border trade.

Box 6: Legal framework to combat transfer pricing abuse: the Arm's Length Principle

Governments need to ensure that the taxable profits of multinational enterprises (MNEs) are not artificially shifted out of their jurisdiction and that the tax base reported by MNEs in their country reflects the economic activity undertaken therein. For taxpayers, it is essential to limit the risks of economic double taxation that may result from a dispute between two countries on the determination of the arm's length remuneration for their cross-border transactions with associated enterprises.

The rules to achieve these goals are found in country domestic transfer pricing legislation, in applicable double taxation treaties, and in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD, 2009c). These rules generally embody the Arm's Length Principle which is endorsed in the OECD and UN Model Tax Conventions. According to this principle, the pricing and other conditions of cross-border transactions between associated enterprises should not differ from those that would be made between independent enterprises in comparable circumstances. It is worth noting that developing countries use a similar principle for customs valuation purposes.

It is inherent to the functioning of multinational enterprises that affiliated enterprises transact with each other. Transfer pricing, *i.e.* the determination of a price for transactions between associated enterprises, is normal and legitimate business practice. Transfer pricing becomes a problem when non-Arm's Length terms are used for transactions, *i.e.* if a company's transfer pricing deviates from what would be agreed in open market commercial terms, and the distribution of profit between affiliated enterprises becomes distorted. This is a particular problem when multinational enterprises misuse transfer pricing to deliberately shift profit towards low tax countries irrespective of where the economic activity that generates such profits actually takes place.

Examples of possible misuse of transfer pricing that developing countries need to monitor are the possible overvaluation of service or royalty fees charged by a foreign head office or group service companies, and the possible undervaluation of the price of goods sold to foreign affiliates. It must be stressed that tax avoidance by transfer pricing should be distinguished from illegal acts such as not recording commercial transactions or falsifying invoices.

Source: OECD Centre for Tax Policy Administration.

In certain circumstances, unitary taxes, also known as 'global formula apportionment', have been suggested as an alternative method to the Arm's Length Principle for the taxation of multinational enterprises (Mold, 2004). In the 1980s a number of states in the US used such a system to tax multinational activity within their jurisdictions (Vernon, 1998). This approach apportions the global income of a multinational enterprise among its various units on the basis of the relative levels of their business activity, as measured by employment, sales, or assets. Proponents' arguments are its administrative simplicity, transparency and the fact that it would make transfer pricing activities obsolete. Companies might arguably also benefit from such an approach, as it could simplify internal accounting practices and thereby reduce their own administrative costs.

The approach is not without problems, however. Difficulties arise in determining the amount of a multinational enterprise's profits to be allocated in this way and the appropriate apportionment formula. These difficulties relate both to reaching any international agreement on the implementation of the apportionment formula and to obtaining and verifying the foreign-based information any one jurisdiction would need to be able to use the approach effectively. Critics also point to issues of arbitrariness, and the risk that it may encourage non-transparent negotiations between multinational enterprises and tax authorities, thereby engendering corruption.

So which way forward for African countries? The consensus is that fighting transfer pricing abuse requires countries to develop specific legislative measures that are adapted to their legal system and economic context, and to build the administrative expertise needed to enforce them. African governments must carefully consider how much resource to devote to transfer pricing. With the administrative capacity constraints and considerable amounts of tax revenue at stake, a pragmatic approach is needed, adapted to the administrative and institutional means available to governments.

International organisations, including the OECD and the International Monetary Fund, have started offering numerous programmes to support African tax administrators in tackling transfer pricing. Some observers actually worry that there are too many overlapping conferences of that kind to attend, as international organisations compete for attention in this strategic policy area (Reisen, 2010). To be effective, policy advice must be well targeted, and go beyond principles to inform decisions at implementation level. This challenge may be addressed by the recently created Task Force on Tax and Development (see Box 12). A crucial complement to policy advice consists of African tax administrations learning from each other and their peers in other regions of the world. African tax administrations can leverage the experience of other countries that have wrestled with this problem, such as Brazil, China, India and South Africa.

Dealing with extractive industries

African policy makers often have the misconception that any attempt they make to substantially tax extractive industries will jeopardise the activity or discourage further investment (African Development Report, 2007). Experts reckon, however, that most natural resources can be taxed, within the bounds of reason, without scaring away investors. Multinational enterprises do not rank tax considerations very high among the concerns they cite as influencing their investment decisions in Africa (Keen and Mansour, *id.*)

The extractive industries in Africa can contribute more to sustainable development than they are currently doing. Countries should develop their resources, while meeting international environmental, social, and governance standards, and use the tax revenue from these industries transparently and effectively. Extractive concessions have to be analysed on a case-by-case basis, however, to evaluate if they are paying the right level of tax to their host country.

Some extreme cases were reported by the IMF in 2009. And where multinational firms fail to abide by minimal corporate governance standards in terms of tax contributions, governments should consider renegotiating concessions. Multinational enterprises may threaten to leave but they are unlikely to actually abandon the exploitation of mines because of a reasonable rise in taxes or royalties. Renegotiation of some contracts is warranted under the notion of odious debt.

African states are entitled to receive a fair deal for the exploitation of their natural resources. Botswana's management of its diamond industry stands as a good example. Negotiations were important to ensure a fair deal for the country. The government renegotiated when circumstances changed and diamond companies became increasingly profitable.

Increased interest in Africa's minerals from Chinese corporations and other new partners is an opportunity for governments to reap the fiscal rewards of competitive bidding. African states must use this opportunity to generate higher public resources. The rise of commodity prices poses many challenges to African countries and their populations; it is all the more important that the commodity boom be harnessed to boost government revenues. The increased public resources from taxing extractive activities should be used to diversify the economy and improve tax administration rather than for rewarding other taxpayers for political reasons.

The Extractive Industries Transparency Initiative (EITI) is unique in its aim to increase the transparency of transactions between companies and government entities, and of the use of revenues by the governments concerned (Box 7). In 2009, Liberia became the first country to comply with EITI.

Box 7: African Development Bank and extractive industries

Through the Extractive Industries Transparency Initiative (EITI), the AfDB works to improve revenue governance in the management of natural resources, especially extractive industries. By supporting the initiative, the Bank seeks to promote fair, transparent, and efficient use of resource revenues to avoid the "resource curse" and a return to conflict over resources. Its support is directed at two main components: *i)* the governance of extractive industries; and *ii)* the implementation of EITI in several countries. In addition, the Bank provides *ad hoc* policy development support to improve the governance framework for natural resources in individual African countries.

As an observer member of the EITI Board, the Bank attends meetings to keep track of progress and better coordinate with other institutions and stakeholders involved in the provision of technical assistance to African countries. The AfDB and the World Bank are developing a new capacity building initiative which aims to improve governance along the extractive industries value chain. The launch of this "EI Governance Initiative" is expected to take place in the first half of 2010 under the sponsorship of the AfDB and the World Bank.

Source: AfDB.

Tackling cross-cutting structural issues

Informality and fiscal legitimacy

— Bringing small enterprises into the tax net

Box 8 below explores practical ways to bring small enterprises into the tax net in Africa. The *Outlook* country surveys show that, for example, Algeria is using a presumptive tax for the mainly informal entrepreneurs. In Zambia a flat-rate 'base tax' for rural areas has been introduced along with 'presumptive taxation' of 3% on gross income for urban areas. Additionally, a 'peddler's licence' has been issued for street sellers. Senegal has also introduced a system aiming to tackle tax evasion.

Box 8: Taxation of small and micro enterprises in Africa: the role of assessment by indices

Since the 1990s, the strategy adopted by African tax authorities has been to benefit from the concentration of the potential of tax revenue. The authorities have adopted relatively high thresholds for direct tax. They have thus used specific services to focus their efforts on a small number of large and medium-sized enterprises with strong potential tax revenue, setting up specific departments for large enterprises and for medium-sized enterprises.

Companies below the threshold for direct tax are currently ignored. Some of these companies are subject to complex tax schemes, which are often based on turnover and are therefore not suited to survival-oriented micro-enterprises. Other companies are subject to simplified tax schemes that do not provide satisfactory taxation of small enterprises that, unlike micro-enterprises, generate much more revenue than is needed to remain afloat. Other schemes attempt to cover these two very different types of companies simultaneously through synthetic taxes that combine assessment by indices with taxes based on turnover or profit estimated using proxy indicators.

These schemes are rarely and poorly implemented, thus undermining the coherence of the tax system and feeding a sense of unfairness, and they are ineffective in mobilising tax revenue. Moreover, the absence of direct tax contributions from many businesses is contrary to the principle of encouraging compliance with tax payments and a sense of liability to the payment of taxes to the state and the local authorities. Bodin and Koukapaizan (2009) support a new segmentation based on a distinction being made between micro-enterprises and small enterprises to enable a feasible way forward towards the taxation of these companies.

Micro-enterprises could be taxed through a synthetic fixed tax: the micro-enterprises would have to pay a fixed tax based on the business activity and a few other easy-to-measure parameters (location, equipment). Micro-enterprises would thus be subject to a simple tax scheme based on an assumed profit. Because the synthetic fixed tax scheme would be simple and easy to implement, it would be possible to involve the local authorities in collecting the tax, since it is conceived as a local resource (Chambas, 2010). Small enterprises, meanwhile, could be taxed on their real profit, which could be assessed through simple accountancy (cash-based accounting). These small enterprises would be subject to the fixed tax but excluded from the application of VAT.

Source: Jean-François Brun and Gérard Chambas, CERDI.

Presumptive taxes, the standard prescription for taxing small informal businesses, can distort economic decisions while absorbing large amounts of administrative resources that could be better used chasing large tax evaders. However, taxing small businesses is still politically desirable for turning the informal sector into a stakeholder in government policies. It should be stressed that there is a point where the cost of administrating a tax will outweigh the revenue. This threshold is much lower in developing countries than in developed ones. Therefore, African tax administrations should conduct a careful cost-benefit analysis when deciding how far to go in their efforts to formalise small businesses.

— Tackling corruption

However, tackling corruption within tax administrations is a priority to establish legitimacy. Corruption undermines tax morale on top of the fact that bribes cut revenues. An appropriately paid tax inspector will be less likely to take bribes. An additional challenge is that talented tax specialists are poached by the private sector, particularly in Africa where tax expertise is scarce. African governments must find solutions, which could include a different pay scale for tax administrators than for regular civil servants. However, excessive use of bonuses and revenue targets can lead to decreased quality and cause frustration amongst tax administrators.

Reducing compliance costs helps with private sector development and lowers the amount of bribe a taxpayer might be willing to pay to avoid declaring and paying tax. Similarly, reducing the number of times a taxpayer needs to interact with tax administrators minimises opportunities for bribery. It also reduces administrative costs and improves compliance. Information technology can also help, as do unambiguous, transparent tax codes. Compliance costs can be reduced by relying more on taxation at source through withholding taxes. The Outlook country surveys reveal that a number of nations, like Uganda and Zambia, have introduced a "Pay as you earn" (PAYE) withholding tax collected by the employer.

Taxpayers who are treated as clients rather than suspected criminals are typically more compliant. Educating taxpayers about fiscal issues brings great benefits for tax collection and contributes to building legitimacy and trust. Well-defined and well-executed educational campaigns using media and new technology can help ensure taxpayers understand compliance requirements. In South Africa and Zambia, for example, tax education campaigns have helped to make the public more aware, increasing voluntary compliance. Customer Relations Managers need to be particularly professional with the biggest clients since the 80/20 rule applies *i.e.* 20% of taxpayers make up 80% of tax revenue. Setting up a "one-stop-shop" where large clients can deal with all tax liabilities at once can be very rewarding.

— Communicating on tax

Similarly, tax administrations can increase their effectiveness by targeting awareness campaigns to client segments with higher compliance risk (Dohrmann and Pinshaw, 2009). Tax administrations should wave the "carrot" of tax education and high-quality service first but compliance cannot be achieved if they do not wave and also use the "stick" of audits, fines and lawsuits wisely. Low tax compliance in many African countries is worsened by the perception of firms and individuals that paying taxes brings them little public service in return. Similarly, the cost of dodging taxes and risk of getting caught are perceived as low. This undermines legitimacy as tax-paying citizens and firms complain that they are unfairly taxed when they see others who do not fulfil their obligations. In many African countries, small and large taxpayers evade tax, while the middle income segment shoulders the bulk of the burden, generating feelings of inequity and frustration. Aid agencies and multinational firms contribute to undermining compliance as local people observe that they often pay little or no tax. Box 9 explores practical strategies to strengthen fiscal legitimacy in African countries.

Box 9: Building fiscal legitimacy

Taxation provides one of the principal lenses through which to measure state capacity, legitimacy and power relations in a society. Joseph Schumpeter noted: "The fiscal history of a people is above all an essential part of its general history." Tax systems are also instrumental to building effective states because taxation is a core manifestation of the social contract between citizens and the state. *How* taxes are raised (and spent) shapes government legitimacy by promoting the accountability of governments to tax-paying citizens, and by stimulating effective state administration and good public financial management.

In 2004, the Malawi Revenue Authority decided to reward tax compliant taxpaying businesses. If at the end of their annual accounting period, legal requirements and liabilities are met, businesses receive tax compliance certificates. In return, certificate holders are assigned Revenue Officers who are in charge of all issues affecting the taxpayer, including reminders, tax information and notices for audits to be carried out. Of broader significance, local banks have unilaterally started using the certificates as an index of overall credit worthiness for businesses seeking loan finance.

The government of Malawi reports that this initiative has led to an increase in tax compliance for large and medium taxpayers and there has been a motivational effect on other smaller taxpayers who are keen to qualify for the certificates. Overall, incentives on both sides have resulted in a climate of improved relationships between the Malawi Revenue Authority and businesses, based on the principle of reciprocity. The way in which banks have used this initiative has considerably reinforced its impact.

DfID's support to the Rwanda Revenue Authority (RRA) has resulted in a dramatic increase in domestic revenue: as a percentage of GDP, it has increased from 9% in 1998 to 14.7% in 2005. Costs of collection have also been reduced. This success is attributed to both the strengthening of RRA's internal organisational structures and processes, and the building of accountable relationships with external partners such as central and local government, a newly growing tax consultancy profession and taxpayers themselves. The RRA now plays an important role in strengthening relationships between citizens and the state, building a "social contract" based on trust and co-operation.

Source: Di John (id.), OECD and DfID.

Improving tax administration

More effective tax administration gives fewer incentives for taxpayers to bribe their way out of fiscal obligations. It also benefits companies by lowering compliance costs, improving transparency and predictability in tax liabilities. Box 10 documents best practices for effective tax administration in developing countries. The Outlook country surveys show that a number of countries have made a policy priority of facilitating the payment of taxes or set up national capacity building strategies for strengthening tax and customs administrations. These include Senegal, Egypt, Comoros, Central African Republic, Sudan and Uganda.

Box 10: Three pillars of modern tax administration

Management and structure

The current trend is a shift away from organising departments by geographical regions towards a focus on tax, sector and functions:

- Taxes can be sub-divided into different segments: Business Taxes (including Corporate Taxes, Value Added Taxes and Excises that are mainly collected from businesses), Transaction Taxes (such as Stamp Duty and Land Taxes on real and financial transactions), Personal Income Taxes, Customs Duties and Export Taxes if any, and Property Taxes.
- Within each tax segment, sector based divisions may be made, to reflect resource availability, all the while keeping in mind that each division allows specialisation and the ability to better understand taxpayer behaviour. These divisions could comprise Large Business Services (if possible divided into sectors such as Banking, Insurance, Oil and Gas, Telecom, Construction and Real Estate, Major Manufacturing, Charities, Specialised Agencies and Bodies such as Universities, Complex Individuals, Municipalities, and others), Small and Medium Enterprises, etc.
- Functional divisions supporting field activity in the sectors would include operational and analytical functions. These include risk and intelligence, compliance, assessment, audit and scrutiny, adjudication and appeals, policy and strategy, analysis buttressed by data mining, finance and legal services. Modern administrations focus on the People Function or Human Resource Development (HRD) so as to address issues of recruitment, retention, training, incentives and natural attrition and so as to adhere to emerging global practices. HRD also monitors staff morale and professionalism in order to react quickly when necessary.

Many African tax administrations have successfully implemented modern management structures. Elements of the above criteria can be found in Kenya and Rwanda who are continuing to enhance their systems through international dialogue and self implementation.

Customer focus

- Stakeholder Engagement: The word "taxpayer" is not used anymore; it is now "stakeholder" or "customer". The use of these new words reflects the realisation that taxpayers have a stake in the tax base and that the administration needs to treat them as customers. Engagement with taxpayers involves continued consultation on different levels – from the ministerial to the technical officer – eschewing any secretive stance that a traditional tax administration has typically taken. At the same time, special favours need to be minimised; rather low headline rates of various taxes is the goal.
- Powers of Intervention: At the same time, modern administrations have to retain their powers of intervention to enable efficient administration, while still using such powers discriminately. Prior co-operation with stakeholders, for example, through Customer Relations Managers, who could pre-verify accounts of large, medium and small businesses, would minimise such intervention. This makes intervention selective and outcome-focused.

This is an area where the South African Revenue Service (SARS) has taken important steps based on customer-centric concerns and learning from other countries experiences.

Information Technology (IT) and the use of analytical capabilities

- The importance of implementing an advanced IT system in a modern tax administration cannot be overemphasised. It allows for rapid filing, the better management of return forms, easy access to information, connectivity across tax offices and among officers, among many other benefits. Such an IT system has to be developed with a significant initial investment to install a data warehouse supported by a business continuity centre and a disaster recovery site. The disaster recovery site would preferably be housed separately from the data warehouse. Similarly a computer network giving simultaneous access to all officers across the country is beneficial.

Interested countries may examine available developing country models in Asia and Latin America to assess their suitability in their own environment.

- A modern IT system has one important benefit. This is the enhancement of analytical capability so that policy measures and strategies may be informed by better analysis. For example, direct tax and VAT compliance, revenue projections, estimate of the tax gap, random survey based understanding and strategy, customer profiling and segmentation, third party information matching, random audit selection, all become immediately feasible. For such operations to become functional, however, tax administrations have to steadily build up a team of analysts from different professions such as economists, operations researchers, social researchers and statisticians.

African countries have to focus on administrative efficiency but, at the same time, have to recognise the inherent link between productive administration and incisive background analysis based on a systemic structure of data and information.

Source: Partho Shome, Chief Economist for Her Majesty's Revenue and Customs, UK.

— How autonomous should tax administrations be?

There is a debate as to whether or not African states should follow the autonomous agency model and set up their tax administrations as institutionally independent bodies or the embedded agency model which keeps them inside the finance ministry or treasury. The first option is supposed to enhance independence and promote change management while the second is said to improve collaboration with policy-makers and other administrations. According to our country surveys, a majority of countries apply the embedded agency model, keeping tax administration inside the finance ministry/ treasury. However, there are also various examples of semi-autonomous tax administrations.

— E-government and taxation

Information technology plays an increasing role in African tax administration (Box 11). The relative scarcity of skilled staff in Africa is such that the productivity of available administrators needs to be optimised. Information technology makes the handling of mainstream clients faster, freeing scarce resources for more complex high-potential clients. Investing in self service options like websites and automated phone service has a significant benefit. The advantages are even greater given the fact that administrations which have adopted software late can move directly into the latest generation of tools.

Box 11: Tunisia: using new information technology to collect more taxes at a lower cost

The use of information and communication technologies for the collection and online payment of taxes is expanding rapidly throughout Africa. Various countries have set up a modern, online filing system for revenue collection (Algeria, Morocco and Cape Verde, among others) or for online payment of income tax (South Africa, Uganda, Cameroon and Gambia, among others). Given the high cost of setting up the necessary infrastructure, some countries have implemented such systems only for the largest taxpayers and certain large corporations. The success of this new practice depends on various factors: access to computer equipment, government incentives (transparency, communication, etc.) and the willingness of taxpayers.

Tunisia has introduced a system for online filing and payments. The system has two schemes. The first scheme (online filing and payment) was instituted in the framework of the 2001 finance law as a voluntary scheme. In 2005, this became mandatory depending on turnover. This scheme has not only reduced the frequency of payments and the time required to file and pay taxes, but it has also produced higher filing and settlement rates, which has reduced the tax-evasion rate and reduced the transaction costs for tax collection.

Evolution of online tax filing

	2002	2007	2008	September	
				2008	2009
Number of registered users	48	813	1845	1634	3503
Number of tax declarations	42	616	1478	1350	2838
% of declarations	87.5%	75.8%	80.1%	82.6%	81%
Amount paid by online filing	26 249	156 564	219 989	250 977	299 516
Revenue from online filing as a % of total revenue.		54.9%	66.4%	68.6%	75.5%

The enterprises that have registered for the scheme are mostly large ones, and many small and medium-sized enterprises (SMEs) are still reluctant to do so. To address their concerns, the Tunisian authorities have introduced the possibility of filing online while paying the taxes in person at a tax bureau. The second temporary scheme (e-payment) was implemented in April 2008. These two procedures have just been reinforced by a third one, which allows taxpayers to pay with a bank card. In addition, Tunisia also put up a one-stop e-window *(Tunisian Trade Net)* intended to simplify procedures for trading across borders, as well as banking and transport procedures. Enterprises also have the possibility of filling out social security contribution forms on line.

Source: Tunisia country note.

In Africa, political influence on tax collectors must be reduced. Furthermore, to reduce the incentive to accept bribes, governments may pay tax administrators on a different scale from the rest of the administration, which is difficult if tax administration is part of a ministry. However, what appears to matter most for lasting tax reform is not so much the institutional set-up but strong high level political commitment to support the work of the fiscal administration in the eyes of taxpayers and other government branches (Di John, *ibid*.).

— Decentralisation, the answer to rapid urbanisation?

The second institutional debate is about fiscal federalism – in particular, which taxes, responsibilities and functions are best centralised and which ones are best managed at the regional and municipal level. Usually, local tax administrations in Africa have some tax competences, such as delivering local business patents. However, as confirmed by this *Outlook*'s country surveys, due to a combination of political reluctance to decentralise power and the severe shortage of capacity, local tax collection is estimated to be of the order of 1% of national income in Africa with a high concentration in large urban centres (Chambas *et al*., 2007). Various countries, including Algeria, Cameroon, Comoros, Côte d'Ivoire, Namibia, Nigeria and Sierra Leone are decentralising their tax administrations. An important benefit of decentralisation is the opportunity to enhance fiscal legitimacy in the eyes of local taxpayers. This should be balanced, however, against the need to keep a low administrative burden for tax payers, as evidenced in Botswana, where efforts have been made to centralise tax collection. Whatever the political merits of decentralisation, the current situation is unsustainable if local authorities are to provide a minimum level of infrastructure and services. Many African countries are seeking to decentralise responsibilities and expenditure but local revenues have not kept pace. Decentralisation would reduce transfers from the national government to sub-national governments and the vulnerability of local resources to discretionary central decisions.

— Improving tax administration widens policy space

There are many benefits to an efficient tax administration besides the revenue it generates. The ease of paying taxes bears directly on private sector development. Where compliance costs are high, businesses are likely to remain small and in the tax evasion zone. Further, the rate at which a country is able to increase its tax base depends on the quality of its tax policies and tax administration. A low capacity tax administration may not offer policy-makers the opportunity to shift from a sales tax to a VAT system, even though this is generally considered economically more efficient. A country with a weak tax administration may be limited to forms of taxation that runs against other policies aimed at bringing businesses and workers into the formal sector.

Harnessing aid

Partly due to the negative impact of the global economic crisis on government revenues, 2008 and 2009 have seen a resurgence of international co-operation and dialogue on tax policy (Box 12). This positive development has arguably made it easier for African initiatives in public resource mobilisation to attract multilateral and bilateral support. Tax administrations are often amongst the most effective parts of the administrations in African countries and yet they face considerable capacity challenges that donors can help them to address (OECD, 2008b and c). Donors should focus on improving the working environment of local fiscal administrations and help build the capacity for those that are missing the human, technical and financial means to run efficient revenue collection activities. Indeed, increasing the share of aid spent on improving tax administrations is one of the aims of the Task Force on Tax and Development recently launched by the OECD. Key challenges, though, as in other sectors of development co-operation, will be to ensure that the proliferation of initiatives: *i)* serve African countries' own priorities for domestic resource mobilisation; *ii)* facilitate access to information, services and training rather than establish a complex web of overlapping initiatives, and *iii)* create net capacity in tax administrations, rather than lead to depletion, with tax administrators being eventually hired by firms or donor agencies who pay higher wages, or taken too frenquently on policy dialogue "tours".

Box 12: Recent initiatives in support of public resource mobilisation in Africa

Multilaterals, regional development banks, donors, think tanks and NGOs have different approaches to domestic and international taxation issues. Some focus on tax administration, others on fiscal policy (Schuppert, 2010). The African Tax Administration Forum (ATAF) has enrolled the support of the African Development Bank, of the joint Task Force on Tax and Development set up in January 2010 by the OECD Centre for Taxation Policy and Administration (CTPA) and its Development Assistance Committee (DAC), and of Germany's International Co-operation Enterprise (GTZ).

The AfDB has also been supporting the African Regional Technical Assistance Centres (AFRITACs) since 2006. At the global level, fiscal issues are traditionally part of the International Monetary Fund's (IMF) domain of intervention, rather than the World Bank's. The Fiscal Affairs Department of the IMF provides technical co-operation *via* assistance, missions and training. The IMF also collaborates with the European Commission (EC), the Inter-American Development Bank (IDB), the OECD, the DfID and the World Bank in the International Tax Dialogue (ITD), a multilateral co-ordination effort amongst tax administrations and bilateral donors, to "encourage and facilitate discussion of tax matters among national tax officials, international organisations, and a range of other key stakeholders". The ITD organises global conferences, one of which took place in Africa in 2009.

In April 2010, the EC has given new prominence to its co-operation in the field of taxation for development by issuing a Communication on "Tax and Development" (European Commission, 2010). Having developed expertise in supporting tax administration reforms in Central and Eastern Europe as a means of financing development, the EC has turned to Africa, for instance by supporting reform in Tanzania, or financing a fiscal transition programme with the West African Economic and Monetary Union (WAEMU). The Extractive Industries Transparency Initiative (EITI) is part of the EU-Africa Governance Partnership and supported by 10 EU Member States and the EC. It encourages the verification and full publication of company payments and government revenues from oil, gas and mining. All EU Member States that support the EITI provide financial assistance, with most using the World Bank's Multi-Donor Trust Fund, and a few giving grants to the EITI International Secretariat. The EC is also a member of the International Tax Dialogue. It uses IMF Regional Technical Assistance Centres for technical cooperation initiatives at country level, and collaborates with the International Tax Compact.

Donor countries with strong fiscal capacities are currently the most involved in supporting public resource mobilisation in Africa through their development agencies. The International Tax Compact (ITC), an initiative of the German Federal Ministry for Economic Co-operation and Development (BMZ), aims to strengthen international co-operation with developing and transition countries to fight tax evasion and avoidance. DfID has been funding research programmes on effective taxation, as well as projects enabling African governments to broaden their tax base.

The Norwegian Agency for Development Co-operation (Norad) provides support in the field of natural resource taxation and management, for instance in the mining sector in Tanzania and Zambia. Germany's GTZ has included tax administration components in its projects in Burkina Faso, Ghana, Mali, DRC, Mozambique, Rwanda, Senegal, Tanzania and Zambia. It also co-operates with regional institutions such as the East African Community (EAC) and the Economic Community of West African States (ECOWAS). The Swiss State Secretariat for Economic Affairs (SECO) supports a multi-donor common fund that facilitates tax administration reform in Mozambique, and provides technical assistance to the Ministry of Finance in Burkina Faso to support tax policy reform.

Sweden, the Netherlands, the United States and Italy also have projects in that policy area. France's Ministry of Finance has been funding technical co-operation, and participates in CREDAF (*Centre de rencontres et d'études des dirigeants des administrations fiscales*), a dialogue and study centre for francophone fiscal administrations, most of which are African. The North-South Institute (Canada) carried out case studies on domestic resource mobilisation in Africa along with the Canadian Development Agency (CIDA) and Research Centre (IDRC), the AfDB and the African Economic Research Consortium (AERC). A Collecting Taxes database is available online in the USAID fiscal reform section, presenting information on revenue performance, tax structure and tax administration.

Finally, several civil society organisations are active in that area. For instance, the Tax Justice Network for Africa (TJN-A) advocates for socially just, progressive taxation systems. Think tanks such as Global Financial Integrity have been documenting tax losses in Africa due to tax evasion. Organisations and networks lobbying against tax evasion and fraud include the Extractive Industries Transparency Initiative (EITI), Transparency International and Publish What You Pay.

— Why invest aid into public resource mobilisation?

A key argument in favour of using aid to stimulate public resource mobilisation is that the returns of a dollar spent on tax systems can generate several dollars in tax collected. In the words of the President of the African Tax Administration Forum, Oupa Magashula, to the participants in the OECD Global Forum on Development in January 2010, it can have up to "a tenfold multiplier effect on states' resources". In this *Outlook*'s South Africa note, we computed that the cost to revenue ratio of the South African Revenue Service has been low and stable, at around 1%. This implies that on average every South African Rand (ZAR) of resource spent on tax administration generates ZAR 99 in tax revenues, net of collection costs. This may not be true at the margin as the first million ZAR of tax revenues are less costly to collect than the last. But, a tenfold multiplier, which implies a 10% cost to revenue ratio at the margin, is plausible if optimistic. An additional benefit for the government is the accumulation of data collected in the process of bringing in taxes, which expands the knowledge base for general macroeconomic and development planning. Conversely, the multiplier effect does not factor in the cost of collecting tax revenues in terms of lost economic efficiency, as taxes always distort economic decisions on investment, saving, or labour in some way.

To put this in perspective, Table 3 reports cost-revenue ratios for African countries based on the Outlook's survey. Benin, South Africa and Swaziland display the lowest cost–revenue ratios, around 1%. However, other countries are not far behind, reporting average cost-revenue ratios of no more than 6%.

Table 3: Cost – Revenue ratio in African countries

Country	Cost - rev ratio	Period average
Sierra Leone	6.00%	2004-2008
Sudan	5.70%	2001-2008
Ethiopia	5.30%	2001-2006
RDC	5.20%	2005-2008
Rwanda	3.20%	2004-2008
Tanzania	3.20%	1996-2008
South Africa	1.20%	2006-2008
Swaziland	1.20%	1996-2008
Benin	0.90%	2008
Argentina	1.80%	2006-2007
Costa Rica	0.80%	2006-2008
Ecuador	1.00%	2006-2009

Note: Total cost of tax administration as reported in general budget, divided by total tax revenue. Source: Author's calculations, based on AEO country surveys, 2010; *Inter-American Center of Tax Administrations, 2010.

Another benefit of spending aid on public resource mobilisation is that it can help recipients and donors progress towards the goals set out in the Paris Declaration on aid effectiveness (2005) and the subsequent Accra Agenda for Action (AAA, 2008): increase the use of country systems by donors, untie aid, enhance aid predictability and maximise the ownership of development strategies by aid recipient countries. Indeed, it is governments who decide how to spend the taxes collected. Wider fiscal space makes for wider policy space. Moreover, since stimulating revenue implies that the government is ultimately to convince taxpayers to pay taxes, this type of aid can help to tighten the social contract that binds citizens with their government. Aid contributes to fiscal legitimacy when invested in reporting public expenditure more transparently and in strengthening the capacity of tax administrations. Traditional aid assistance, on the other hand, empowers the government to set priorities independently of taxpayers. We now take stock of recent initiatives in support of public resource mobilisation in Africa.

— Making the most of aid for public resource mobilisation, and managing risks

Donors should not become a substitute for local administrations. Initiatives like taking over operational management of a revenue or customs authority can be very efficient in the short term. However, in the long run, this strategy fails to build legitimate and sustainable public institutions. A significant feature of more successful recent tax reform efforts is that they have not just been externally driven. Britain's support to the Rwandan Revenue Authority and Germany's help for the Ghana Revenue Authority are cited as works that secured sustained increases in administrative effectiveness and a high degree of local ownership.

Aid should not undermine the relationship between the fiscal administration and other parts of the government. Assistance should focus on capacity building programmes that also help the general administration and governmental activities. For example, sponsoring a population census and urban land register helps to assess and collect personal income and urban property taxes but also helps civil servants and policy makers formulate and drive social and urban planning.

More generally, discussion about enhancing the capacity of African tax administration must be accompanied by a general discussion about governance, transparency and the eventual use of increased public resources by the government. Increasing the capacity of the fiscal administration, or enhancing the tax base, will not bring long term results if reforms are not visibly linked to productive strategies, including aid policy. Taxes can only be a "facilitator" for the building of capable states, and then only as long as the state is legitimate and its actions are based on a legitimate political consensus. It is therefore important not only to bring politics back into taxation and governance issues but also the specific context of each country.

The participation of developing countries' tax officials in the global community of tax professionals should be encouraged. The emphasis should be on sharing knowledge and best practices through dialogue. South-South cooperation should be strengthened and supported by the donor community. Transparency in inter-company trade must be increased through country-by-country reporting and the adoption of international accounting standards aimed at tackling transfer pricing. International support should be mobilised to help developing countries while recognizing their differing needs. These needs must be highlighted at international meetings. African tax administrations must be helped to take advantage of such international groups and meetings.

Donors need to deliver on their pledges of policy coherence by putting pressure on their own mining conglomerates to strike decent deals with African nations. They should encourage revenue transparency, including country-by-country reporting, by their companies so that civil groups can question unacceptable deals. Better reporting would also ease the job of African tax administrations in their attempt to report the magnitude and sources of fiscal expenditure to their governments and people. Donors could offer legal assistance to developing countries signing a deal with a multinational enterprise, even if it was based in a different country. Donors should not poach the scarce African tax expertise to meet their needs for local experts.

Revenue conditionality is another way in which aid can be made more conducive to effective domestic resource mobilisation. On the one hand, matching donor contributions and collected taxes could encourage a more active revenue collection policy. Donor budget support would be calculated as a pre-agreed percentage of a government's collected tax revenues, with an upper limit to the amount of budget support and a provision for the matching percentage to come down as the government's capacity to raise revenue strengthens. This approach is an incentive to revenue collection by design. State officials know that raising extra revenue will result in additional inflows of donor resources. For this system to work, donors must commit to the medium and long-term through the development of trust funds.

On the other hand, revenue conditionality can focus on how aid affects the way tax is collected, not just how much revenue is collected. This implies a focus on vertical equity, tax payer awareness and education, transparency, strengthening tax-expenditure linkages and bargaining with taxpayers and organised groups when designing revenue conditionality and support for tax reform efforts. The major challenge involves the willingness of donors to make aid flows predictable and reliable, putting into practice agreements on good donor practice embedded in the 2005 Paris Declaration.

Balancing the tax mix

Concentrating taxes on a narrow set of taxpayers serves no good use. An unbalanced tax base puts the burden on too few tax payers and this means tax rates need to be high, and compliance enforced harshly, to generate substantial tax revenues. An optimally broadened tax base not only generates the highest possible tax revenues, but also widens a government's policy options. A balanced tax-base enables lower statutory rates on all, or selected taxpayers. A broader base can lead to a better mix of increased tax revenues at lower statutory rates.

Diversifying the tax mix

African countries with unbalanced tax mixes should prioritise the collection of direct (corporate and personal) and indirect taxes (VAT). Algeria, Angola, Chad, Congo, Equatorial Guinea, Gabon, Nigeria, and Sudan have all taken steps on these lines. It would be wrong to conclude though that resource-rich countries should (even partially) replace taxes on extractive activities with other types of taxes. Indeed, some states need to generate more public revenues from resource activities. Resource-rich states should save at least part of their resource tax revenues away for rainy days and for future generations. Some were already moving in this direction before the global economic crisis, by running large current balance and budget surpluses.

Clearly, there is more to increasing a country's tax share and tax effort than exhorting its tax administration to be more active, or even for donors to support hard-pressed tax officials. Countries obviously do not decide themselves whether they will belong to the resource-rich club or be a fragile/post-conflict nation. They can and should, however, adapt their public resource mobilisation strategy to their own circumstances. A country's characteristics should clearly be taken carefully into consideration when deciding a course of fiscal reform. Institutions like ATAF should help African countries to identify others who have been through the same experience and can help.

Dealing with trade liberalisation

Trade liberalisation in Africa needs to be purposively sequenced with domestic tax reform. The policy response to declining trade-related tax revenues as a result of trade liberalisation has to be designed in the context of a broader reform agenda. Policy options include cutting domestic expenditure, relying on the growth effects of trade liberalisation, replacing all Non-Tariff Barriers (NTBs) with new tariffs, and increasing other tax revenue. In practice, cutting expenditure is hardly an option for most African countries, given their development needs and poverty reduction challenges. As for relying on growth effects, Part I of the Outlook has shown they were too uncertain for sound policymaking. Replacing NTBs and remaining import quotas by tariffs can offset some of the revenue losses while liberalising trade, but will not be enough in most countries. As a result, the policy response to the impact of trade liberalisation on government revenue will hinge around an ambitious tax reform agenda.

As we have seen in the previous sections, this agenda might include a combination of strengthening tax administration capacity, deepening the tax base, dealing with informality and relying on a wider range of taxes. In other words, policymakers face the challenge of replacing existing "easy-to-collect" trade taxes with more politically-demanding forms of taxation. Another difficulty is sequencing: in order to minimize fiscal losses, tariff cuts should be introduced once the benefits of tax reforms in terms of revenues are tangible, in particular in fragile states. This means that trade negotiations should be informed by the progress in overall tax reform.

Evidence shows that this reform agenda can work in developing countries, but that middle-income countries are more successful at recovering revenue than low-income countries. Baunsgaard and Keen (*ibid.*) finds that around half of the low and about one-third of mid-income countries do not offset the loss of trade tax revenues. In Africa, some countries like Kenya and Egypt have a poor track record of offsetting revenue losses from trade liberalisation. Others, like Malawi and Uganda have done better (IMF, 2007). Overall, the Outlook finds that the most successful countries in terms of replacement of trade tax revenues are those that have diversified their tax base rather than those that focused primarily on VAT. The experience of post-conflict states like Rwanda and Uganda shows that this is possible (Box 4).

Reforming urban property taxes

Certain taxes, such as urban property taxes, could yield a much higher return if decentralised, as local governments usually have a more direct access to the relevant information. Cape Verde and South Africa have successfully decentralised urban property tax collection. The physical proximity makes it easier to service smaller-scale payers. To unlock this potential, local tax administrations need greater skills and their rights and obligations should be clearly enshrined into law. Policy co-ordination and harmonization by the central tax administration and government would help to ensure that municipalities compete fairly with one another and avoid inconsistencies and overlaps in the overall tax system. To avoid a feeling of harassment, it is important that municipalities focus on a narrow set of high potential and administratively feasible taxes (Chambas *et al.*, 2007).

The main obstacle is political. The more wealthy and influential sections of society would be affected by this tax. Municipalities would have to make a credible commitment to upgrade urban infrastructure to win acceptance. Yet, as collection of urban property taxes would require an up-to-date cadastre of African urban centres, it would have a momentous side benefit – bringing clarity to property rights, at least in city areas. Consequently, it would improve access to credit as demonstrable ownership of real estate can be used as collateral for a loan.

Conclusion

As several African nations celebrate 50 years of independence in 2010, it is time for a continent that still relies too much on often volatile and unpredictable external flows to take a new look at taxes – a potential untapped source of billions of dollars. It is time also for donor countries to consider the benefits they can get from giving more help to set up stable, broad-based tax systems in African nations.

African tax administrators, under serious capacity constraints, face a daily battle against informality, evasion, corruption and fraud, pressure to grant exemptions, etc. Yet there is a more optimistic side to the story. Following a decade of reforms, levels of tax revenues collected in Africa compare well with those of countries at similar stages of development. African politicians are looking for ways to improve collection further.

Tax revenues should not be seen as an alternative to foreign aid, but as a component of government revenues that grows as the country develops. One of the development dividends of effective tax systems is greater ownership of the development process, whereby the government shapes an environment that is more conducive to foreign and domestic private investment, sustainable use of debt and effective foreign aid. The challenge is therefore for African countries and their partners to reverse the vicious circle of aid dependence shifting government accountability away from citizens towards donors, and trigger a virtuous circle of aid becoming redundant by supporting public resource mobilisation.

In the short run, strategies towards more effective, efficient, and fair taxation in Africa typically lie with deepening the tax base in administratively feasible ways. Policy options include removing tax preferences, dealing with abuses of transfer pricing techniques by multinational enterprises and taxing extractive industries more fairly and more transparently. In the long run, the capacity constraints of African tax administrations must be released to open up policy options.

Notes

[1] Data on tax revenues is not available for Comoros, Eritrea, Malawi, Somalia and Zimbabwe.

[2] LICs are Zambia, Tanzania, Mozambique, Eritrea, Uganda, Gambia, Kenya, Central African Republic, Zimbabwe, Comoros, Somalia, Niger, Mali, Madagascar, Burkina Faso, Senegal, Rwanda, Guinea-Bissau, Ghana, Guinea, Congo, Dem. Rep., Burundi, Malawi, Sierra Leone, Togo, Chad, Mauritania, Ethiopia, Benin, Liberia.

LMICs are Nigeria, Sudan, Egypt, Arab Rep., Djibouti, Lesotho, Tunisia, Cameroon, Morocco, Cape Verde, Congo, Rep., Sao Tome and Principe, Angola, Cote d'Ivoire, Swaziland.

UMICs are Algeria, Botswana, Gabon, Namibia, Equatorial Guinea, Seychelles, Mauritius, Libya, South Africa.

[3] Although the term covers states with heterogeneous characteristics, most fragile states are low income economies with weak public administrations. More than half of the fragile states in sub-Saharan Africa are post conflict countries. See Annex of DfID (2005) for a proxy list of fragile states.

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