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GOOD AND BAD NEWS FROM AFRICA

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Voices oft he South on Globalization is a monthly newsletter intended to inspire a meaningful North-South Dialogue by raising awareness for global interdependences and by offering a forum for voices from the South in the globalization debate. Each edition presents short analyses or commentaries from a Southern perspective on one particular issue of the globalization process.

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Some Pleasant Surprises

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 and close the gap between its infrastructure and the rest of the world's, the continent requires an annual investment of $93 billion over the next decade, says a landmark new study.

However, as several African nations celebrate 50 years of independence in 2010, the study titled 'African Economic Outlook (AEO) 2010' points out, 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, it adds.

The AEO is published each year, jointly by the African Development Bank (AfDB), the Organisation for Economic Cooperation and Development (OECD) and the UN Economic Commission for Africa (ECA), with the financial support of the European Commission and the Committee of the ACP (African, Caribbean and Pacific) group.

The study notes that 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.

One of the pleasant surprises the AEO springs is that "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, it adds

On the other hand, the study says: "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, it argues, 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," states the AEO.

In the short run, it adds, "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. ***(continued on page 6)***

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, says the African Economic Outlook 2010 that includes a special study on Public Resource Mobilisation—or taxation.

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, says the special report, 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, 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 study argues: 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.

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, the study points out. 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. 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?

NO ALTERNATIVE TO AID IN THE SHORT RUN

The srudy points out that 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. ***(page 5)*** ➤

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, according to UNCTAD. International trade is thus largely an activity between different divisions of the same enterprise operating in different jurisdictions.

A special study included in the AEO 2010 states that 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, *for example,* 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.

One such study estimates that total trade mispricing in 2006 was more than USD 500 billion. Another 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. 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, says the study included in AEO 2010. "Governments argue that they cannot make all details of the extractive industries public and that they have limited influence on companies." Indeed. Countries compete for the scarce managerial and technical skills needed for resource extraction. 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.

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.

Countries should therefore use tax incentives with care, cautions the special study. "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." ☑

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).

Why Review African Tax Systems Now?

(Continued from page 2)

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. The most dependent countries are found in sub-Saharan Africa along an arch that crosses the continent from North-West to South-East.

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, says the study.

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.

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. 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). 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.

MAJOR FINDINGS

Based on the 50-country *African Economic Outlook 2010* survey, the study 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.

The study 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.

The study also 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 cooperation.

- 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.

– Jerome Mwanda ☑

Some Pleasant Surprises

(Continued from page 1)

A few notable messages from the African Economic Outlook are:

- 80 percent of the African countries covered in the AEO (47 of the 53 countries) registered positive growth in 2009 as compared to only 10 percent of rich OECD countries.

- Africa is one of the most undiversified regions in the world: approximately 80 percent of its exports are based in oil, minerals and agricultural goods.

- Resource-related taxes have increased from 5 to 15 percent of GDP (gross domestic product) over the last 15 years. In Equatorial Guinea alone, over 95 percent of taxes collected come from natural resources.

- Low Income Countries in Africa still collect less than 15 percent of GDP in taxes while Upper Middle Income countries collect 35 percent, almost on par with OECD countries.

THE OTHER SIDE

But the AEO also points out that Africa has been hit particularly hard by the global financial crisis and this has put to an abrupt end a period of relatively high economic growth on the continent. But average growth is expected to rebound to 4.5 percent in 2010 and 5.2 percent in 2011.

It finds that Africa's GDP growth was slashed from an average of about 6 percent in 2006-2008 to 2.5 percent in 2009.

The GDP or GNI (gross national income) is a measure of a country's overall economic output. It is the market value of all final goods and services made within the borders of a country in a year.

It is often positively correlated with the standard of living, though its use as a stand-in for measuring the standard of living has come under increasing criticism and many countries are actively exploring alternative measures to GDP for that purpose.

"Given the pace of population growth this means that growth of per capita GDP came to a near standstill. Average growth is expected to rebound to 4.5 percent in 2010 and 5.2 percent in 2011, although the recession will leave its mark," says the document tabled on May 24, 2010 at the annual meetings of he Boards of Governors of the African Development Bank Group in Abidjan, the economic and former official capital of Côte d'Ivoire.

Henri-Bernard Solignac-Lecomte, Head of the Europe, Africa and Middle East Desk at the OECD Development Centre has both good and bad news.

"The good news is that the continent has proved resilient to the crisis. The bad news is that, despite rebounding growth next year, the downturn could make it more difficult for some African countries to meet the Millennium Development Goal of halving the number of people living in poverty by 2015," he said.

The report points to an uneven recovery on the continent. It expects Southern Africa, which was worst affected in 2009, to recover more slowly than other regions with an average ➤

The recovery of the Ivorian economy continued in 2009, despite the context of international crisis. Growth reached 3.6% in 2009 and inflation fell. Picture: /www.africaneconomicoutlook.org/en

➤ growth of almost 4 percent in 2010/2011. East Africa, which best weathered the global crisis, is projected to again achieve the highest growth with more than 6 percent on average in 2010/2011. North and West Africa are both expected to grow at around 5 percent and Central Africa at 4 percent during the same period.

The Outlook also predicts an uneven recovery across sectors. In 2009, Africa's export volumes declined by 2.5 percent and import volumes by about 8 percent. Sectors such as mining and manufacturing were particularly exposed to the fall of commodity prices and global trade in goods and services.

Other sectors, notably non-tourism services and agriculture, were more resilient and mitigated the effects of the downturn. In fact, in most African countries the agricultural sector benefited from good harvests due to favourable weather, although in some countries, bad harvests exacerbated the effect of the global crisis.

Analyzing the policies that cushioned the impact of the crisis, the AEO says: "Africa proved to be more resilient to the global crisis than some observers had feared thanks to prudent macro policies prior to the downturn that resulted in improved economic fundamentals in many African countries."

This, together with sustained official aid flows, earlier debt relief and loans by the International Monetary Fund, the World Bank and the African Development Bank provided space for adopting counter-cyclical policies, which cushioned the impact of the crisis. Nonetheless, policy challenges remain.

"The prospect of only a moderate recovery in a number of African countries makes it even more pressing to address the structural problems which existed even before the global crisis, and which reduced growth potential and led to high poverty levels," said Léonce Ndikumana, Director of Development Research Department of the African Development Bank.

– **Jaya Ramachandran | IDN-InDepthNews** ☑