AID AS A CATALYST FOR DOMESTIC RESOURCE MOBILIZATION IN AFRICA

Background Paper

Dr. Ngozi Okonjo-Iweala
Co-ordinating Minister for the Economy
and Hon. Minister of Finance, Nigeria

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1. *Background*. According to the AU, improving domestic resource mobilization (DRM) in African countries would be "pivotal to the successful implementation of the second decade of NEPAD". This policy note summarizes some of the key policy issues involved in improving domestic resource mobilization in African countries, with a particular emphasis on the catalytic role which could be played by official development assistance (ODA).

A. DOMESTIC RESOURCE MOBILIZATION IN AFRICA

2. Domestic revenue mobilization in developing countries is important for <u>two</u> reasons.
   a. First, it provides governments in low-income countries with additional revenues which are urgently needed for investments in physical infrastructure and social services. <u>This observation is even more pressing given the anticipated decline in future ODA</u>. In particular, sub-Saharan African countries would need to mobilize resources to finance funding gaps for infrastructure investments (about $120 billion per annum), as well as other post-2015 health and education programs.
   b. Second, strengthening tax institutions is often viewed as an important component of state building which helps to improve accountability relationships between government and its citizens. More effective and transparent tax systems can therefore contribute to broader governance reforms in developing countries.

3. Recent data.
   a. According to a recent AfDB report, tax revenue collection has improved in many African countries since the 1990s. Overall tax receipts in Africa increased from about 22 percent of GDP in 1990, to about 27 percent of GDP in 2007. However there was some variation across countries. Tax revenue in low income African

countries was below 15% of GDP – the conventional IMF threshold for satisfactory tax performance. The performance in middle income countries in Africa was around 22% of GDP, and for upper middle income countries in Africa around 35% (identical to OECD countries).

b. *Tax receipts and ODA*. According to data from the AfDB, in 2008, Africa raised about $441 per capita in tax receipts, and received about $41 per capita in aid inflows. Thus aid accounts for less than 10% of tax receipts in Africa as a whole. Aid exceeds tax revenues in only 12 countries (e.g. Burundi, Guinea Bissau, Sierra Leone, CAR, Liberia, Rwanda, Mozambique, the Gambia etc.)

c. While tax revenue collection has improved in many African countries since the 1990s, there are many leakages and "gaps" to be plugged, and more effective tax administration could contribute to improving revenues. Overall, the IMF estimates that a further increase in tax revenues of about 4 percent of GDP is attainable in many low-income countries.

B. AID AS A CATALYST FOR DOM. RESOURCE MOBILIZATION

4. Investing ODA in building tax systems can yield impressive returns. According to the OECD, every $1 of ODA spent on building tax administrative capacity generates about $350 in incremental tax revenues. However, despite the potentially high return for investing development aid in tax-related assistance, only limited funds have been targeted at this sector. The OECD estimated (based on 2005 data) that only 1.7 percent of bilateral aid for economic-related programs was targeted at improving tax institutions.

5. There have been some recent initiatives by international institutions (e.g. the UN, IMF and World Bank), regional organizations and bilateral donors to support tax revenue administration in developing countries. These include the OECD Task Force on Tax and Development and the International Center for Tax and Development supported by DFID/NORAD. There are also various initiatives which provide a forum for peer discussions on tax issues such as the International Tax Dialogue (ITD), the African Tax Administration Forum (ATAF), and the Inter-American Center of Tax Administrations (CIAT).

C. SUGGESTED AREAS FOR ODA INTERVENTIONS IN DRM

6. *Tax policy design.* More expertise is needed for tax officials in developing countries in conducting tax policy analyses and designing tax policies which are appropriate for local country conditions. As many low-income countries become less dependent on trade taxes, there is the need to implement coherent tax policies that improve compliance, and also to introduce measures which broaden the base for personal and corporate income taxes. Similarly, for VAT policies, further revenue increases may be obtained by broadening the base of goods which are taxable, and simplifying tax administration by avoiding multiple tax rates. Developing country governments also need to carefully review tax incentive policies which create sizable tax exemptions, but sometimes result in only limited benefits for governments. ODA can assist in building the technical capacity of tax officials in these countries in the short- to medium-term.

7. *Tax policy administration*. Revenue administration in developing countries is often hampered by low capacity and remuneration of tax officials, weak organizational structures, and lack of modern, computerized risk-management techniques. For many low-income countries, tax administration is influenced by political factors as political will could support tax crackdowns to reduce rent-seeking and improve compliance. At the same time, political interference may lead revenue authorities to overlook tax non-compliance by wealthy or influential individuals. While there has been progress in recent years, there is opportunity to improve compliance, for example, the VAT "gaps" is estimated at around 50-60 percent in some developing countries, compared with developed country estimates of about 13 percent. African governments, supported by donor agencies, should focus on further strengthening their tax institutions.

8. *Transfer pricing and multinational firms*. Multinational firms – operating in developed and developing countries – often engage in tax avoidance by assigning their profits to branches located in lower tax jurisdictions. Within a large multinational group, various branches typically exchange goods and services – such as purchasing intermediate products, rental of property, or leasing of licenses. Transfer pricing refers to the assignment of prices and charges between the related parties which determines the taxable profits reported by branches of the multinational firm. Internal trade within a multinational group may therefore occur at distorted prices which re-allocate profits away to lower tax locations. Although a challenge for both developed and developing countries, transfer pricing schemes may result in large tax revenue losses for developing

countries due to weaker tax administration capacity in these countries. Donors can assist developing countries by promoting more transparent reporting by multinationals and tax havens in order to tackle cross-border tax evasion. The UK Government during the recent G8 meetings has commenced work in this area.

9. *Natural resource dependent economies.* Resource-dependent economies face additional challenges in mobilizing domestic tax revenues.
    a. First, many resource-dependent economies face challenges in negotiating equitable fiscal arrangements for resource revenues. There tends to be wide information asymmetries between foreign contractor firms and host government officials resulting in lopsided contract agreements. This is a potential area where ODA can play a useful role in supporting capacity-building in resource-dependent African states. Developing country governments, with donor support, can invest more in building their technical capacities, in improving their negotiation skills, and in researching more on international best practices prior to negotiating their natural resource contracts.
    b. Second, high revenues from natural resource rents reduce incentives to invest in building institutions for collecting domestic taxes. Some empirical estimates suggest that an additional $1 from petroleum revenue reduces non-petroleum tax revenues by about 20 cents. The consequence is an increased reliance on natural resource rents and limited capacity of tax authorities.

10. *Leveraging private sector financing*. ODA should also be used more smartly to leverage private financial resources in the future.
    a. ODA can be used to leverage non-concessional debt (both domestically and internationally) for bankable projects in developing countries. During consultations for the HLP MDG Panel, Standard Chartered and Barclays bank expressed interest in exploring such arrangements.
    b. In many cases, the participation of some multilateral institutions in co-financing arrangements or fund syndications sends a reassuring signal to the markets, and can result in greater private sector interest as well as loans with extended maturities and lower interest rates.

11. *Operators in the informal economy*. For developing countries, an important challenge in improving tax compliance concerns ways to increase tax revenues from the informal sector. The informal sector comprises about 40 percent of GDP in many developing

countries. However, the lack of formal financial records for such businesses operating in this sector presents various challenges for tax authorities. The main culprits tend to be an intermediate group which falls between subsistence producers and large companies. For example, in Nigeria, we conducted an exercise comparing two databases: the official registry of companies versus the official taxpayers' database. We observed that about 75 percent of "registered" firms were not in the tax system. Moreover about 65 percent of registered tax payers had not filed their tax returns in the past 2 years! We observed that the majority of tax evaders were firms such as contractors, professional services providers, and landlords. Unpaid real estate rentals in Nigeria were estimated at about $250 million per annum. Such audit exercises can enable governments and donors to focus enforcement on specific sectors which can yield a good "bang for the buck".

12. *Post-conflict countries*. There are additional challenges faced by post-conflict countries where tax revenue institutions and broad tax bases need to be re-established. There have been some broad successes in countries such as Liberia, in improving customs administration, raising corporate taxes, reforming tariff policies, and overall strengthening of tax administration procedures. In Mozambique, following the end of the civil war in 1992, similar reforms have resulted in tax revenue increases from about 8.5 percent of GDP in 1992 to about 15 percent of GDP in 2011.

13. *Supporting knowledge exchange.* Development assistance could also support knowledge exchange between tax officials in both North-South and South-South fora. Peer learning platforms and professional networks also provide a setting for sustaining tax reforms in developing countries. Within countries, a coordinated approach is needed, leveraging the knowledge of domestic tax officials and adapting tax policies to existing political realities.

14. *Strategically supporting CSO organizations.* Donor institutions can also strategically support civil society organizations (CSOs) in developing countries to promote greater dialogue on tax-related issues. CSOs can demand greater transparency in the operations of tax authorities, require more accountability from government authorities on the use of tax revenues, and monitor performance indicators to assess the progress of their national revenue authorities.