Domestic Resource Mobilization in Africa

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Agenda 2063: The Africa We Want

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  "We reviewed past plans and commitments, and pledge to take into account the lessons as we implement Agenda 2063. These include putting mobilization of the people and their ownership of continental programmes at the core; the principle of self-reliance and **Africa financing its own development**; the importance of **capable, inclusive and accountable states and institutions** at all levels and in all spheres…

  We hereby adopt Agenda 2063, as a collective vision and roadmap for the next fifty years and therefore commit to speed-up actions in the following areas:

  …

  *o. **Strengthen domestic resource mobilization***

  …

  Build effective, transparent and harmonised tax and revenue collection systems and public expenditure" [my emphasis]

Context

- Poverty remains stubbornly high in Sub-Saharan Africa.
  - Despite a fall in poverty rates, the number of people living on less than \$1.25 per day has increased from 205 million in 1981 to 414 million in 2010 (PovcalNet, World Bank).
- Many of the so-called Fragile and Conflict Affected States (FCAS) are the least likely to meet any of the MDGs.
- The Monterrey Consensus (2002) outlined six leading actions to meet the challenge of financing the MDGs, and the first among these was domestic resource mobilization (DRM).

Context

- DRM involves fiscal revenue mobilization (tax and non-tax revenue), strengthening the domestic financial sector, increasing financial inclusion.
  - In this presentation, I will focus mostly on issues related to taxation and revenue mobilization.

- The international community has also acknowledged the importance of DRM (e.g. support for initiatives such as the African Tax Administration Forum (ATAF) (2009) and the European Commission Communication on Tax and Development (2010)).

Context

- DRM is also gaining prominence in discussions surrounding the post-2015 agenda.
- DRM – now referred as “domestic public finance” is emerging as a top priority for the upcoming FFD conference in Addis Ababa in July 2015.
  - Developing countries have achieved revenue increases of 2-3% of GDP since Monterrey, with some achieving increases up to 5% (UN, 2015).
  - Several challenges remain: insufficient domestic revenues, insufficient resources at the sub-national level, harmful tax competition across and within countries, lack of transparency and participation in budget processes etc.
  - ‘Relative’ decline of ODA compared to other financial sources.

Why is DRM Important in the African Context?

- First, most donor countries have failed to live up to the long-standing commitment to deliver 0.7% of GNI as aid even in good times.
  - Donors have fallen short of the 2005 G8 Gleneagles commitment to raise the volume of aid and double aid to Africa by 2010.
  - Beyond the numbers, there is also a sense that donor views on the purpose of aid are constantly changing; increasing skepticism about the development results achieved from decades of aid flows.

Why is DRM Important in the African Context?

- Second, “there is no case of a high investment path not backed up by high domestic savings” – *Commission on Growth and Development (2008).*
  - Although countries can rely on foreign capital to finance investment, capital inflows to developing and emerging economies have been very volatile.
  - Taxation is fundamental to state-building (Herbst, 2000; Tilly, 1975) and forms the foundation of the social contract between the state and citizens…

Why Is DRM Important in the African Context?

…

– Heavy reliance on resources other than broad-based domestic taxation can be a disincentive to develop institutional capacity and accountability to citizens, and ultimately promoting prosperity.

– Aid dependent countries tend to be more responsive to donor than domestic priorities (where the two differ).

Why Is DRM Important in the African Context?

- Third, it is now widely expected that external resources will not be enough to sustain developmental performance beyond 2015.
  - External resources such as aid will not be enough to meet the financing needs of an ambitious post-2015 agenda.
  - Domestically mobilized resources, through taxes and non-tax revenues, will be expected to play an increasingly important role.

The Post-2015 Development Framework and Implications for DRM

- 17 SDGs and 169 targets – Open Working Group of the UNGA
  - "Goal 17. Strengthen the means of implementation and revitalize the global partnership for sustainable development

    Finance

    - (Target) 17.1 Strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection. "

- The target is not specific as to how developing countries are going to be supported.

  - FFD conference in Addis Ababa in July might be the opportunity to do so.

Emerging FFD Agenda and Implications for Africa

- Role of foreign aid and international donor community is being downplayed while the role of domestic financing and international private capital is being strongly emphasized.

- For example, the HLP report believes that the majority of the money to finance post-2015 goals will come from domestic sources, given the progress made by low- and middle-income countries in raising domestic revenues.

- There is a rapidly emerging consensus that private capital will play a far greater role in the emerging FFD agenda than it did in Monterrey.

Emerging FFD Agenda and Implications for Africa

- Since the FFD conference will take place in July, it could also potentially send a strong signal that the post-2015 agenda will be backed by hard financial commitments.

- These developments have important implications for poorer countries that are still reliant on aid, and that cannot attract sustainable foreign capital.

- An agenda that deemphasizes aid could thus increase the financing burden on low income countries in Africa.

Emerging FFD Agenda and Implications for Africa

- More importantly, the discussions that have taken place thus far are devoid of any realistic assessment of the financing potential of domestic taxation, non-tax revenue mobilization or other alternative financing options.

- Furthermore, integrating development and environmental financing agendas (as recommended by the HLP), changes the scale of the financing discussions dramatically.

- As financing gap estimates get incredibly big, these may alienate stakeholders and make the entire discussion unrealistic and unproductive.

Emerging FFD Agenda and Implications for Africa

- Financing gap estimates also assume that lack of financing is the binding constraint; as a result, they tend to ignore or pay insufficient attention to the efficiency and effectiveness of public expenditure in developing countries.

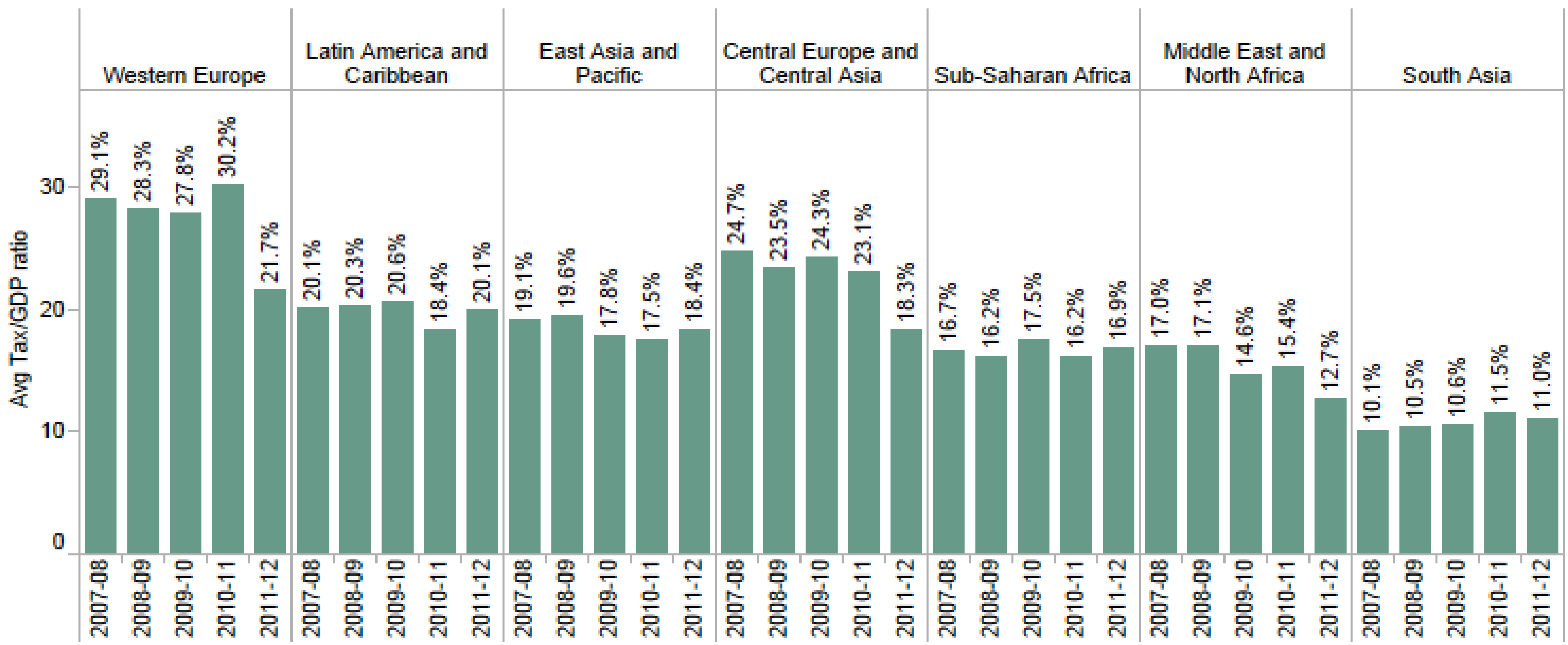
- Given the high expectations surrounding developing country DRM efforts and DRM's contribution to financing ambitious post-2015 goals, let us then examine whether DRM expectations, especially as they relate to Africa are reasonable.

Recent Trends in DRM in Africa

- We restrict our analysis to tax and non-tax revenues and use two alternative data sources:
  - USAID's Collecting Taxes Database (USAID, 2012).
  - The African Economic Outlook's fiscal database (AEO, 2012).
- Tax collection has been rising in Africa and crossed over the 20% of regional GDP mark in 2009. However, the ratio is less than 17% in half of African countries (AEO, 2010; Atisophon et al, 2011).

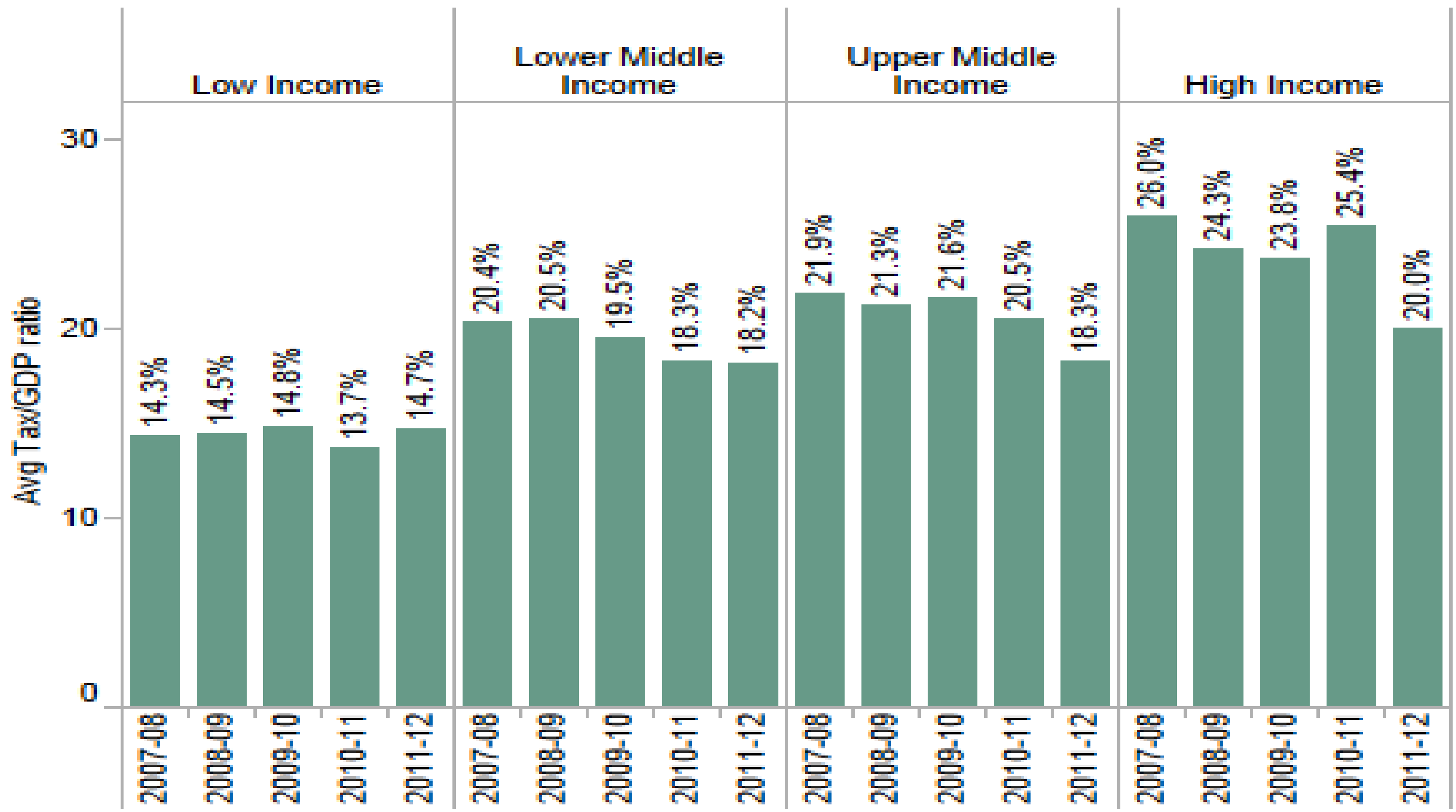
Recent Trends in DRM in Africa

- **Figure 1: Tax/GDP ratio across regions**



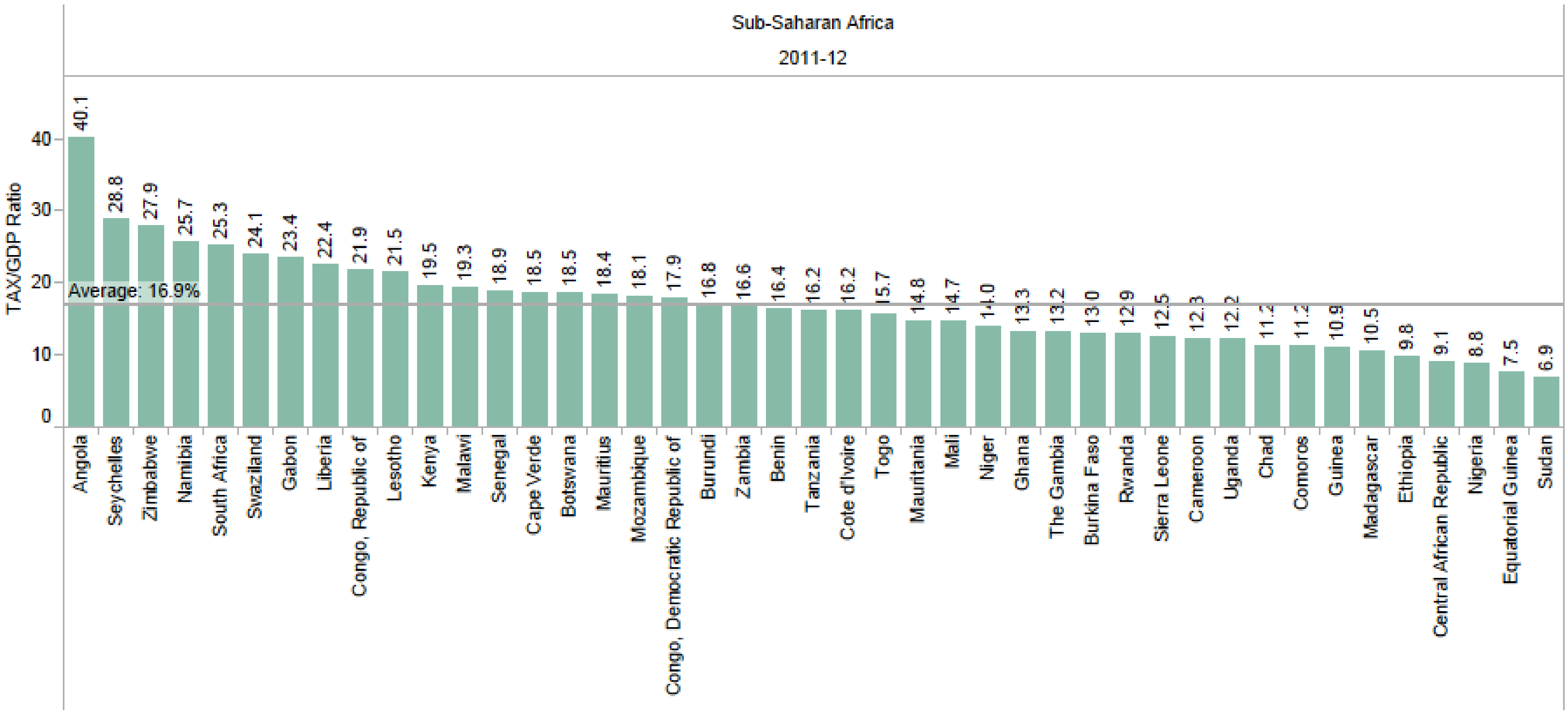
Recent Trends in DRM in Africa

- **Figure 2: Tax/GDP ratio across income groups**



Recent Trends in DRM in Africa

- **Figure 3: Tax/GDP ratio across sub-Saharan Africa**



Recent Trends in DRM in Africa

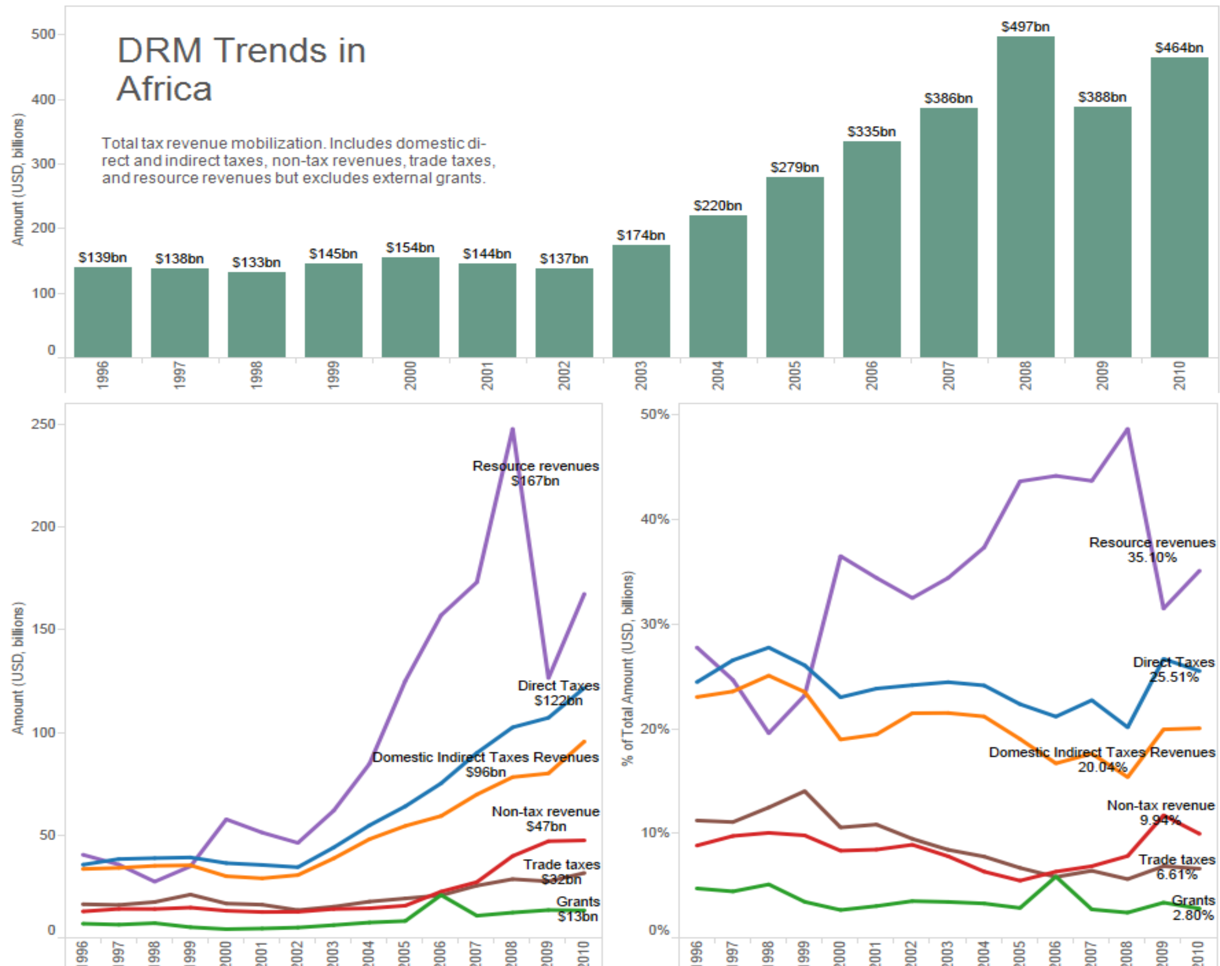
- What are the drivers behind these trends?
  - Revenue mobilization has started to increase since the early 2000s, when growth started picking up.
  - Total tax revenue mobilized was almost stagnant from 1996 to 2002 but then increased from around $137 billion in 2002 to a high of $497 billion in 2008.
  - This performance coincides to some extent with major reforms to tax policy, administration and tax structures across many countries in the African region.
    - Introduction of the Value Added Tax.
    - Establishment of autonomous revenue authorities (ARAs).

Recent Trends in DRM in Africa

- What are the drivers behind these trends?
  - Majority of the increase in tax mobilization has been driven by revenue mobilized from the natural resources sector.
  - Resource revenues made up nearly 49% of Africa's tax mix in 2008. These tend to be quite volatile.
  - Domestic direct and indirect taxes are also increasing rapidly, and with less volatility, while trade taxes continue to decline (in percentage terms) as countries further liberalize trade.

Recent Trends in DRM in Africa

- **Figure 4: Composition of domestic revenue mobilization in Africa (1996-2010)**



Recent Trends in DRM in Africa

- Domestic tax revenue is already more than 10 times the size of total foreign aid to the region.

- This means that the majority of development financing is mobilized domestically even in the poorest region.

- But the forces driving revenue mobilization are causing a split between countries:
  - Successful mobilizers rely on natural resources.
  - Unsuccessful mobilizers are working from too shallow a tax base despite significant tax effort (including donor support).

Recent Trends in DRM in Africa

- **Figure 5: Tax performance and administration (2011-12)**

	Avg Cost	Avg Tax Staff
East Asia and Pacific	1.19	0.45
Central Europe and Central Asia	1.13	0.99
Latin America and Caribbean	1.26	0.33
Middle East and North Africa	3.17	0.46
South Asia	1.83	0.27
Sub-Saharan Africa	2.93	0.32
Western Europe	0.93	1.19
US and Canada	1.53	0.69

Recent Trends in DRM in Africa

- The proliferation of tax exemptions prevents countries from maximizing their revenue potential.

- Exemptions contract the revenue base, complicate tax systems, and open the door to political capture. More importantly, exemptions have a ratcheting effect; once in place they are hard to remove.

- For example, in Burundi, the IMF estimates the cost of exemptions to be up to 1.5% of GDP in recent years (Girukwigomba, 2010). In Ethiopia, customs exemptions ranged from 3.7% to 4.2% of GDP from 2005 to 2008.

Tax Effort Index for Africa

- The tax/GDP ratio is a widely used taxation indicator; it is easy to obtain and interpret; it provides a quick overview of trends across countries.

- However, a low (high) tax/GDP ratio does not necessarily mean bad (good) performance.

- Tax mobilization may increase by imposing punitive costs on the population, rather than building a better state-citizen compact.

- A more sophisticated approach is to calculate a tax effort index.

Tax Effort Index for Africa

- The tax effort index is the ratio between the share of actual tax collection and taxable capacity.

- We estimate taxable capacity as the predicted tax/GDP ratio calculated using the estimated coefficients of a regression specification, taking into account the country specific characteristics that influence tax mobilization.

- In other words, we control for the factors that influence the tax/GDP ratio to predict what individual African countries *should* be collecting, given their structural characteristics.

Tax Effort Index for Africa

- Taxable capacity in this analysis is estimated using a panel dataset of 49 African countries from 1996 to 2010.

- Using Le et al's (2012) specification, we consider the following empirical specification for estimation:

$$\frac{TAX}{GDP} = \beta_0 + \beta_1 GDPPC + \beta_2 TRADE + \beta_3 AGRIC + \beta_4 POP + \beta_5 GOVEFF + \varepsilon$$

Tax Effort Index for Africa

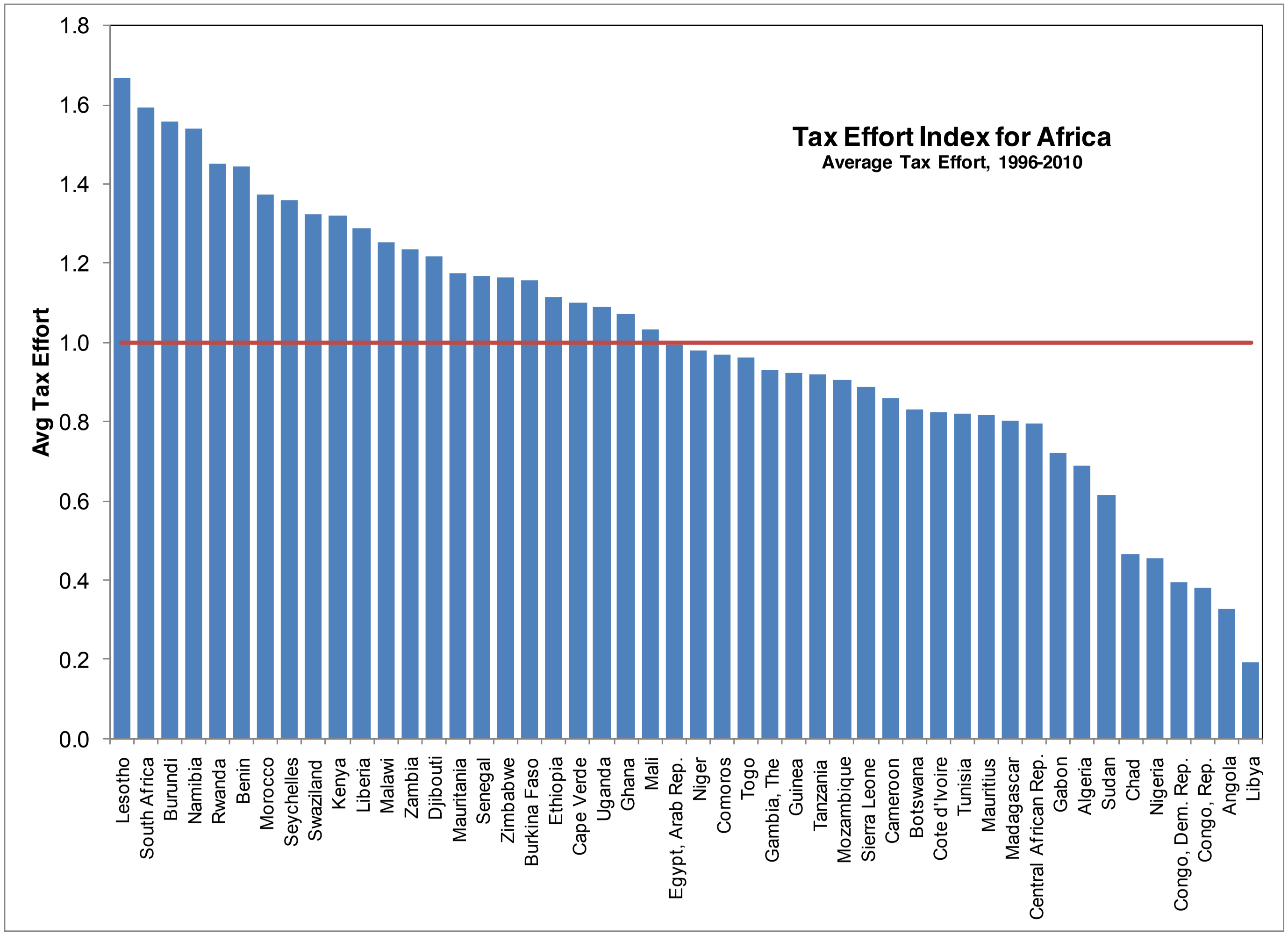
- Tax effort for each country and year is estimated according to the definition above and an average value is calculated over the whole period to derive a single value for each country in the sample.

- A tax effort index value above 1 indicates "high tax effort", while an index value below 1 indicates "low tax effort".

- The correct interpretation of the index is that high tax effort countries are utilizing their tax bases well to increase revenues while low tax effort countries may have relatively substantial scope to increase revenue collection from the existing tax base.

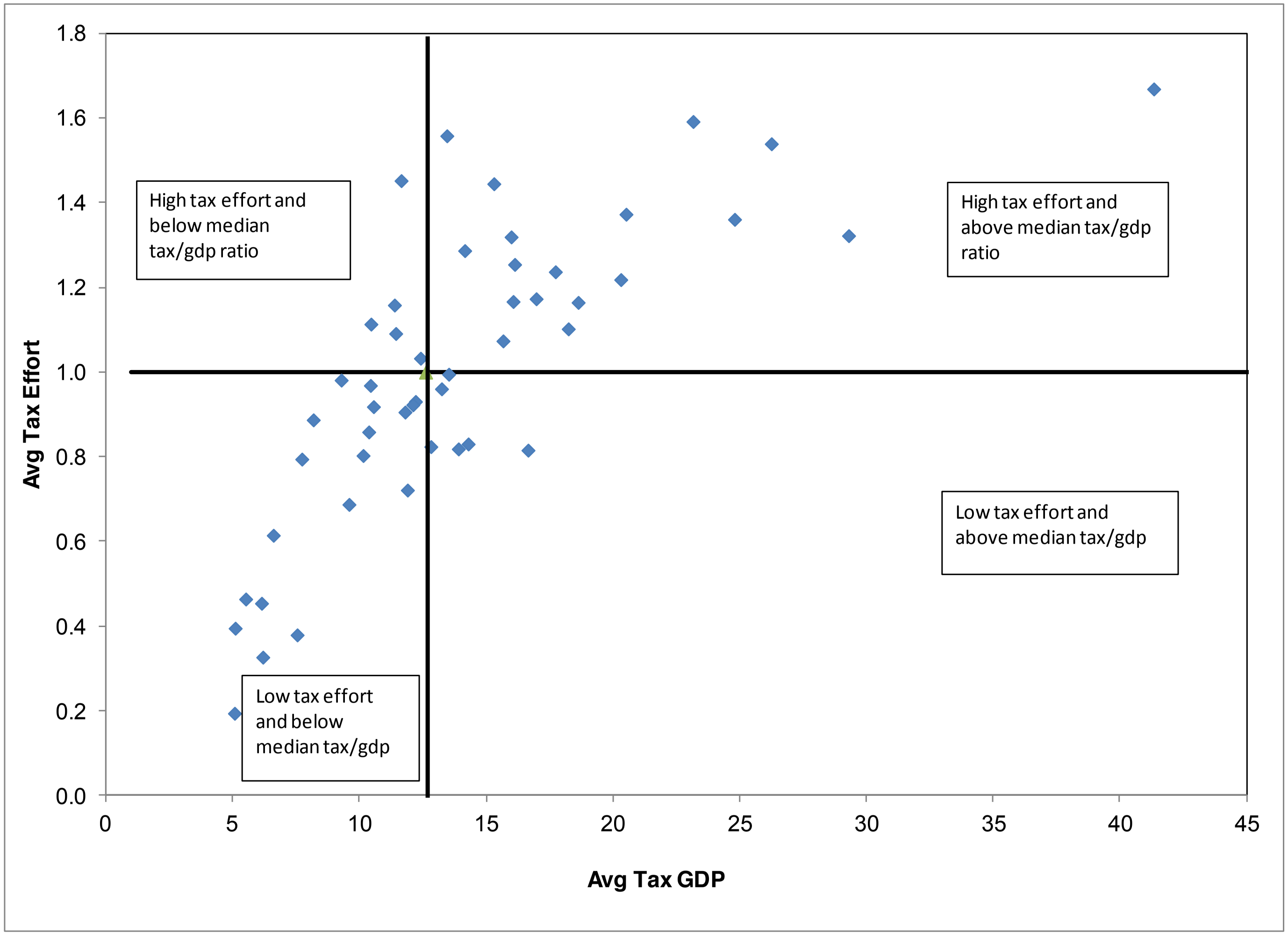
Tax Effort Index for Africa

- **Figure 6: Tax effort index for Africa**



Tax Effort Index for Africa

- **Figure 7: Tax effort index for Africa and revenue mobilization, 1996-2010**



Tax Effort Index for Africa

- Key take-aways:
  - A number of African countries are already making significant tax effort.
  - Low effort countries are resource rich: these countries may have the potential to increase revenue mobilization but the prevalence of resource related revenues may be weakening the incentive to make greater effort to capture the domestic tax base.
  - How does sub-Saharan Africa compare with other regions on tax effort?
    - We estimated a tax effort index for all countries.
    - Actual tax collection in sub-Saharan Africa (at the regional level) is consistently above predicted tax collection…

Tax Effort Index for Africa

- Key take-aways:
  - How does sub-Saharan Africa compare with other regions on tax effort?
    - The tax effort index is consistently above 1, especially since the early 2000s (up to the financial crisis).
    - The tax effort index is lower (below 1) in other developing regions such as South Asia and East Asia.
    - Tax effort has been increasing since the mid-2000s in Latin America.

Tax Effort Index for Africa

- Key take-aways:
  - Tax collection remains low despite significant tax effort in many countries:
    - Structural factors limit how much revenue countries can hope to mobilize before constraining growth, investment and other objectives.
    - Expectations regarding the extent to which domestic revenue can finance ambitious post-2015 goals in Africa, and address huge ‘financing gaps’, may need to be tempered, especially given that domestic revenue is already more than 10 times the size of aid to the region

Conclusions

- Tax issues cannot simply be reduced to goals and targets aimed at increasing the tax/GDP ratio.

- Donor contributions to building tax capacity in the region remains relatively small and tends to be concentrated in a handful of countries.

- From the perspective of Africa’s development partners, DRM as it features in the post-2015 FFD agenda should be repurposed to be singularly concerned with investing in responsible and accountable governments