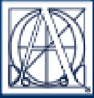

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Global Strategic Analysis

AFRICA: Shift to domestic taxation faces challenges

Monday, March 12 2007

SUBJECT: Challenges in shifting toward domestic taxation as a source of government revenue in African states.

SIGNIFICANCE: A shift away from government revenues derived mainly from external sources, such as trade tariffs, toward domestic sources, such as income or value-added tax, has been an important target since the IMF- and World Bank-led wave of structural adjustment in the 1980s. While this goal has been adopted into the economic reform agendas of many African governments, problems with political institutions continue to hinder its implementation. Moreover, doubts remain about the potential benefits.

ANALYSIS: Relying more on domestic taxation is a potential reform for states seeking development. This type of reform first emerged in the 1980s, when the main international financial institutions (IFIs) -- the World Bank and IMF -- stipulated privatisation and trade liberalisation as conditions for lending, thereby limiting African states' trade-related sources of revenue. They were thus forced to look elsewhere for revenue-generating alternatives to aid and debt.

Social spending goals. After nearly two decades of structural adjustment with a focus on reducing public expenditure on wages, IFI reform programmes shifted in the late 1990s to a focus on poverty reduction in low-income countries through increased social spending, such as on health or education, through a framework based on the Poverty Reduction Strategy Paper. In the process of implementing reforms -- liberalisation, privatisation as well as fiscal spending caps -- the IFIs were confronted with the issue of the volatility of government revenues based on trade (particularly commodity exports), which could fluctuate significantly, making long-term planning difficult and risky.

In the region, both import and export duties have fallen as a percentage of GDP: from 4.9% and 1.0% in the early 1990s to 3.5% and 0.4% in the early 2000s, respectively. Tax revenues in sub-Saharan Africa also fell from 16.3% of GDP to 15.9% in the same period. More stable sources of revenue, such as income and value-added tax, were promoted.

The 'vicious circle'. However, in sub-Saharan Africa, two main factors -- mostly to do with the nature of political institutions -- have limited the ability of the state to collect and rely upon domestic taxation at both personal and corporate levels:

1. **Institutional capacity**. Since independence, African governments have typically been characterised by limited institutional capacity, making determination and collection of domestic taxes at the local level complicated. Assessing income or agricultural production, for example, has proved difficult. It has been easier to concentrate on transactions over which the government has more control:
    - **Trade tariffs**. The government's control over the introduction and exit of goods across the border through official ports facilitates tariff enforcement.
    - **Export commodities**. Through state controlled or regulated commodity marketing boards, a tax on the sale of agricultural or mineral commodities can be levied.
    - **Extractive industry**. A percentage of revenues from mineral exports, such as oil or copper, can also be collected from mining companies (often a foreign company in partnership with a domestic or state-owned company) as part of the terms of the mineral concession.

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2. **Legitimacy and credibility**. Several factors weaken the legitimacy and credibility of government in general, thus damaging any attempt at taxation:

    - **Limited benefits**. The public has a perceived lack of 'return' on its taxes. In a modern state, taxation represents part of a transaction in which there is an implied contract between the state and the citizen, under which the citizen should see some benefit -- eg, increased safety and security, public health, etc -- in exchange for their taxes.
    - **'Informalisation'**. In sub-Saharan Africa, these public goods, in short supply at independence, have often deteriorated since then, leading to a lack of credibility on the part of the state. This can contribute to the 'informalisation' of economic activity, like the black market or smuggling -- though most economic transactions take place at least in part in the formal economy.
    - **Myopia**. Dictatorial regimes with a long-term horizon may invest in social goods, but predatory or short-term autocrats may instead capture state resources for constituencies, at the expense of development. Indeed, some regimes may actively discourage economic development, since economic activity could provide a source of funding for political opposition.

    Ultimately, these two factors make implementing reforms more difficult, and can lead to a 'vicious circle', whereby the government's failure to deliver public goods undermines its ability to collect revenues that would fund potential reforms, further diminishing its credibility.

Aid effect. Under structural adjustment and subsequent reforms, fiscal spending caps and liberalisation have often unintentionally exacerbated this situation:

- **Social spending squeeze**. Fiscal caps have successfully limited overall expenditure. However, contrary to the IFI's intentions, the proportion of government spending on social goods has continued to be compromised by spending on public sector wages. This is despite the fact that the size of the public sector in African states is not extraordinarily large in per capita terms -- in fact, public employment in many African countries is lower than in Asian developing countries or in Western developed countries.
- **Aid volatility**. Despite attempts at donor harmonisation and a shift towards budget support instead of project assistance, aid flows remain difficult to predict. This renders the budget all the more volatile, many states in sub-Saharan Africa are reliant for a significant proportion of their budget on aid.

Delivering development. 'Developmental states' in Asia -- which experienced high rates of economic growth in the 1980s, and to which African states are often contrasted -- markedly relied on low levels of taxation and public spending at early stages in their development. Spending on social goods was not a priority. Instead, attention was focused on improving conditions for domestic industry, with an eye towards growth driven by competitive exports.

If Africa wants to follow suit and boost domestic industry, its low stock of physical infrastructure (roads, power, communications etc) will hold it back. However, there are signs that initiatives aimed at improving the business climate are resulting in a shift towards expenditure on infrastructure:

- The UK Commission for Africa report highlighted the role of physical infrastructure in promoting increased investment (see AFRICA: Blair Commission proposes large changes - March 16, 2005).
- There have also been moves to increase African investment in infrastructure, for example through state pensions (see AFRICA: Pension funds hold promise for infrastructure - April 25, 2006).
- The donor community seems to recognise this shift, after years of focus on education and health rather than roads and electricity (see AFRICA: Donors increase attention on investment - August 8, 2005).

Outlook. Measures which improve the business environment could lead to increasing government capabilities to collect corporate taxes. This in turn could work to counter the vicious circle, and increase government capacity to deliver social goods.

CONCLUSION: African states have faced significant challenges in shifting to domestic sources of revenue as part of IFI enforced economic reform strategies designed to increase social spending. However, while the IFIs are unlikely to adopt an Asian 'developmental state' as a model, due to its economic heterodoxy, there are signs that a focus on similar strategies to boost investor confidence -- such as a focus on physical infrastructure -- is emerging. A key issue will be the extent to which this is balanced against donor demands for traditional social spending on health and education.

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