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São Tomé and Príncipe: Domestic Tax System and Tax Revenue Potential

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Abstract

São Tomé and Príncipe is very open and highly depends on imports resulting in high indirect tax revenue. At the same time, the production and export base are very narrow, leaving the authorities with a small domestic tax base. For these reasons, the country compares unfavorably with neighboring economies and other island countries, in terms of domestic revenue in percent of GDP. The paper describes the domestic tax system in São Tomé and Príncipe and uses cross-country empirical analysis to reach a benchmark tax potential for the country. The paper reaches the conclusion that whether São Tomé and Príncipe becomes an oil producer or not, it is more sustainable for it to rely on non-oil domestic revenue—a less volatile and less exhaustible resource—to finance current expenditures. To meet the country's increasing development and social objectives, the authorities need to mobilize sufficient domestic resources. The paper offers a number of fiscal reforms to reach this goal, including implementation of the new tax laws, reduction of exemptions, tax system reforms, and improvement of the tax administration.

JEL Classification Numbers: E62, H2, H21, H24, H25

Keywords: São Tomé and Príncipe; Tax revenue Potential; Optimal Taxation; Tax Reforms

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I. INTRODUCTION

1. **This paper studies São Tomé and Príncipe's domestic revenue performance, discusses factors affecting tax performance and weaknesses, examines developments in domestic revenue mobilization, and offers recommendations on tax reforms.** The paper notes that the country's tax performance is highly dependent on import taxes and excise duties, particularly on imported petroleum products, resulting in a volatile domestic revenue source. In addition, the country's tax administration remains very weak, resulting in weak tax enforcement and an environment of low tax morale. As a result, the country's domestic tax performance remains below potential. The paper recommends that the authorities mobilize domestic revenues by strengthening the tax administration, fully implementing the new direct tax reforms, and streamlining the existing indirect taxes. When the tax administration becomes more effective, the introduction of new indirect taxes could also help mobilize additional domestic revenues.

2. **The paper is organized as follows:** Sections II and III analyze recent developments in domestic revenue performance and reforms. Section IV studies São Tomé and Príncipe's tax potential using statistical evidence and cross-country empirical analysis. Section V offers some recommendations to reform the country's tax system and move toward fiscal sustainability. Finally, Section VI concludes the discussion.

II. BACKGROUND: WHY IS DOMESTIC REVENUE MOBILIZATION NEEDED IN SÃO TOMÉ AND PRÍNCIPE

3. **São Tomé and Príncipe is one of the smallest countries in the World.** The economy is highly undiversified, with cocoa production as the main, albeit small, commercial crop and the tourism sector still in its infant years. In recent years, the public sector has been supported by large inflows of oil signature bonuses, which have been a key source of financing for large and increasing public spending. Since 2005, the country received oil bonuses of about $78 million, of which only $12 million are remaining (Table 1).[1] Oil exploration that already took place did not confirm the existence of commercially extractable reserves. Additional drilling is expected in late 2009, pushing any prospects for oil production to 2015. If commercially extractable oil reserves are not found, and if additional oil bonuses are not received, the existing balance of the National Oil Account (NOA), which holds oil bonuses, may run out by 2014, given the annual withdrawals from the NOA to finance the central government budget.

[1] Oil bonuses for four out of the six blocks were received in 2005 and 2007. Receiving the oil bonuses from Blocks 5 and 6 is uncertain, given disagreements between the investors in the two blocks and the Joint Development Agency. See IMF country report number EBS/08/64.

Table 1. Sao Tome and Principe - Oil Bonuses and National Oil Account (million U.S. dollars)				
	2005	2006	2007	2008
Oil bonuses	49	0	29	0
National Oil Account (year-end balance)	23.3	8.6	14.9	12.2

4. **São Tomé and Príncipe is a highly open economy.** The country's dependence on imports results in a high dependence on import duties and excises as the main sources of domestic revenue. However, given that petroleum products made up about 39 percent of imports in 2008 and excises on petroleum products made up about 18 percent of total tax revenue, reliance on import duties and excises, in particular on petroleum products, adds significant volatility to the main source of revenue for the budget. At the same time, the production and export base in the country are very narrow and the administrative capacity to collect taxes is very limited, leaving the authorities with a small domestic tax base. For these reasons, São Tomé and Príncipe's tax performance compares relatively unfavorably with neighboring countries and other island economies.

5. **Mobilizing domestic revenues on a more sustainable basis will be key to meeting pressing development and social needs**. The central government budget is burdened by a large public sector wage bill, which leaves little room for other crucial expenditures. At the same time, domestic revenue collection is constrained by a small tax payer base and a small economic base, as well as administrative shortcomings.[2] Despite efforts to strengthen fiscal prudence, increasing current public expenditures have persistently exceeded domestic revenues. With uncertain oil prospects, which, if they materialize, would fall far into the future, and with a dwindling stock of oil signature bonuses, public expenditures must fall and/or domestic revenues must increase to fill the gap. This is all the more important since other sources of revenue—mainly external donor support—is not sufficient to meet the increasing spending pressures. In particular, to successfully meet the social and poverty alleviation objectives under the country's Poverty Reduction Strategy Paper (PRSP) and also move closer to achieving the Millennium Development Goals (MDGs),[3] the authorities will need to mobilize domestic revenues (direct and indirect taxes) to create the much needed fiscal space to allow for increased social spending.

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[2] The tax payer base is significantly reduced by the lack of tax-payer registration, reflecting both weaknesses in the tax administration side, where enforcement is week, and the weak voluntary tax compliance. See below.

[3] One core element of the MDGs is for all low-income countries to increase their own resource mobilization and devote budget revenues to priority investments.

III. Recent Domestic Revenue Developments in São Tomé and Príncipe

6. **São Tomé and Príncipe's domestic revenue is dominated by indirect tax revenue.** Domestic revenue has increased from 13.2 percent of GDP in 2001 to 17.7 percent of GDP in 2008. Over the period 2001-2008, total tax revenue made up on average about 84.8 percent of total domestic revenue, with indirect taxes making up on average about 69.7 percent of this total (Figure 1).

A. Tax Revenue

7. **Tax revenue has shown significant reliance on indirect taxes (excise taxes and import duties).** Excise duties are levied on domestically produced and imported goods at rates varying from 5 to 20 percent, except on the following products: petroleum products (15–130 percent), beverages, including alcohol (5-130 percent), vehicles (15–50 percent), and tobacco (100-250 percent) – see Appendix III. There is also an excise tax on services at 5 percent. Revenue from these taxes has averaged 35.5 percent of total tax revenue and about 5.2 percent of GDP, over the period 2001-2008. In 2008, excise duties on imported petroleum products alone made up almost half of total excise duties, and alone averaged about 11.7 percent of total tax revenue; reaching about 3 percent of GDP. On average, over the period 2001-2008, tax revenue has been increasing, albeit at a recently slower rate, mainly due to increases in excise taxes and the introduction of taxes on imported petroleum products.[4]

8. **Despite recent trade liberalization measures, customs' collection increased by about 39.3 percent per year over the period 2001–08.** This is mainly due to the large increase in imports, induced by foreign investment in construction and tourism projects. Custom duties range between zero and 20 percent. On average, collected custom duties amounted to 25.6 percent of total tax revenue over the period 2001-2008, reaching 3.7 percent of GDP. Together with excise duties and other smaller taxes (mostly stamp duties), these indirect taxes make up about 69.7 percent of tax revenue, reaching about 10 percent of GDP.

9. **Direct taxes on income (corporate, personal, and other smaller taxes) constituted about 30.3 percent of tax revenue, averaging 4.3 percent of GDP during 2001–08.** Recently, the direct tax system has changed. In January 2009, the personal income tax was changed from a flat rate of 13 percent to a progressive rate of 10–20 percent, while corporate income tax rates were changed from a progressive range of 25–45 percent to a single rate of 25 percent. Other taxes, including an urban property tax, made up less than 1 percent of tax revenue over the period 2001-2008. (See Appendix II for more details on the new tax laws).

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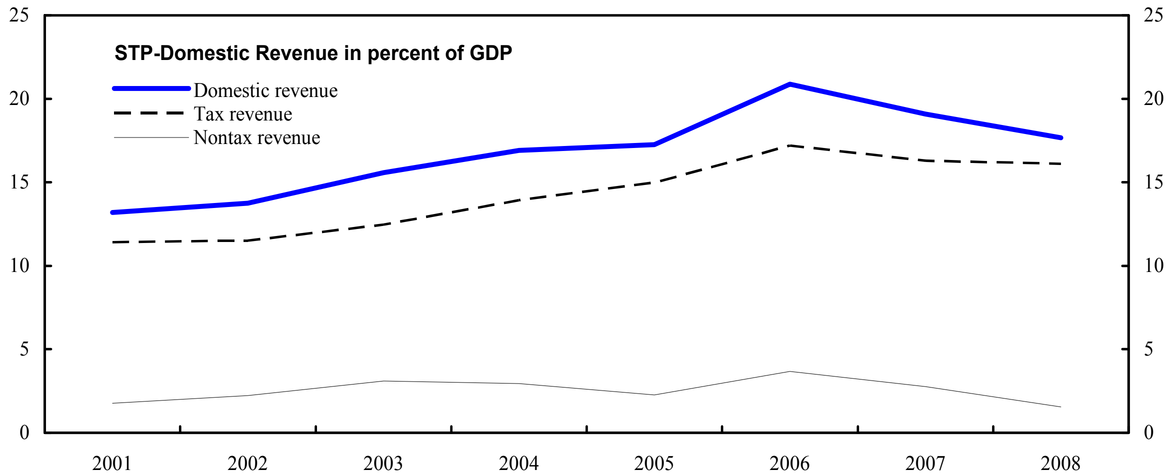
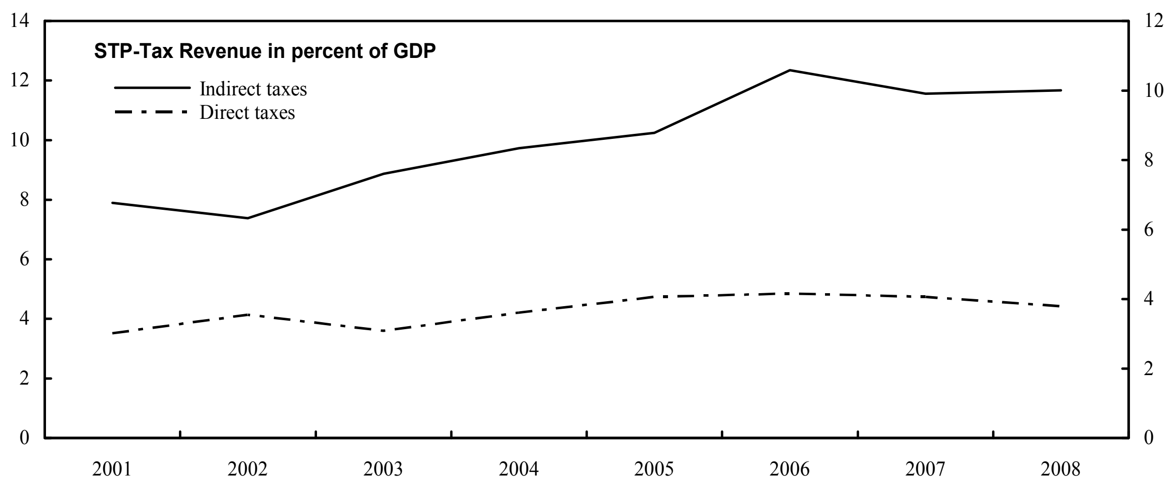
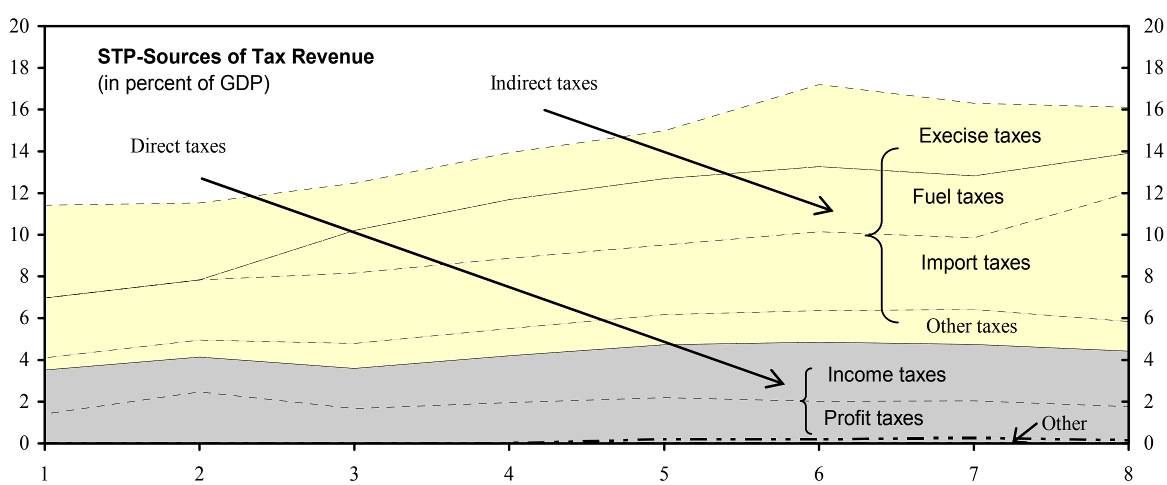
[4] In 2007, a fall in petroleum product imports significantly affected tax revenue during that year. The high international oil prices during the majority of 2008 resulted in higher excise tax revenue from imports of petroleum products.

Figure 1. São Tomé and Príncipe—Developments in Domestic Revenue, 2001-2008







Source: Sao Tome and Principe authorities and IMF staff estimates.

10. **São Tomé and Príncipe's tax revenue has a relatively weak response to changes in income.** Tax revenues have not kept up pace with GDP growth in São Tomé and Príncipe, compared to selected other economies (Table 2). All taxes have recently had tax buoyancies that are below unity (i.e. inelastic—taxes respond slowly to changes in income).[5] That is, the increase in tax revenue was smaller than that of economic growth, resulting in a smaller tax-to-GDP ratio during that year. This was mainly driven by the slower growth in indirect tax revenue, due to the fall in revenue from excise duties on petroleum products.

Table 2. Comparative Tax Buoyancies, 2007 1/

	Total taxes	Profit taxes	Income taxes	Execise taxes	Import taxes
Barbados	2.0	1.1	-1.6	3.5	3.7
Fiji	1.6	1.7	2.0	1.5	-0.1
Ghana	1.3	-0.4	1.6	0.9	2.0
Mauritius	0.3	5.5	1.1	0.9	-0.9
Maldives	4.8	1.8	…	1.8	1.6
Sao Tome and Principe	**0.7**	**0.9**	**0.7**	**0.5**	**0.6**

Source: IMF statistics.

1/ Tax buoyancy measures the responsiveness of tax revenue to changes in nominal GDP.

B. Non-Tax Revenue

11. **Non-tax revenue has averaged about 2.5 percent of GDP over the period 2001–08.** The main source of this revenue is from fishing royalties (from the European Union) and an in-kind oil payment from Nigeria.[6]

C. Overall Position

12. **Over the period 2001-2008, total domestic revenues persistently fell below current public expenditures** (Figure 2)**.** As a benchmark, in order to assess the sustainability of the fiscal position, it is useful to assess the level of domestic resources that can finance current expenditures.[7] Current expenditures have consistently outpaced total domestic revenues by an average of 40 percent over the period 2001–08, implying an average domestic resource gap on the order of 6.7 percent of GDP. While increases in the

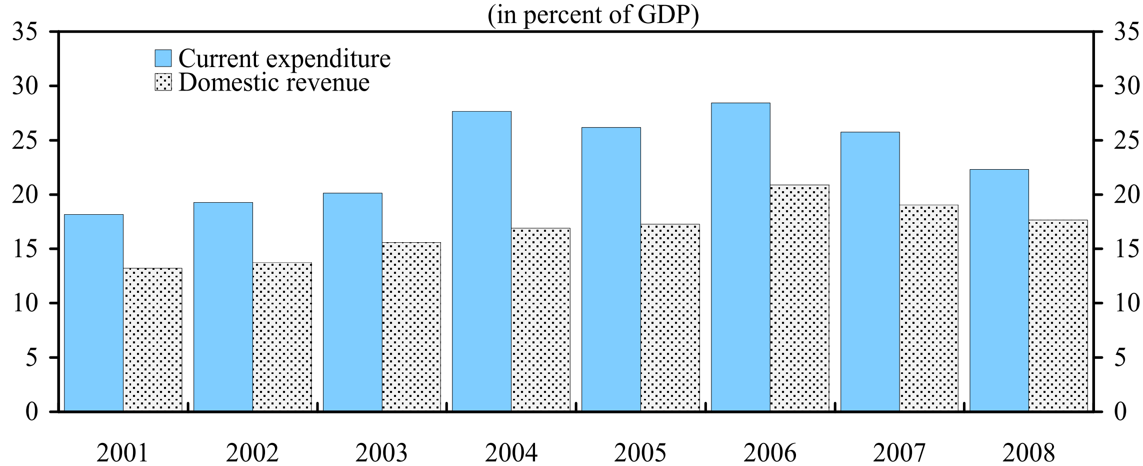
[5] Tax buoyancy measures the responsiveness of tax revenue to changes in nominal GDP. A buoyancy of 0.5, for example, implies that a 1 percent increase in GDP results in 0.5 percent increase in tax revenue.

[6] As part of the agreement between Nigeria and São Tomé and Príncipe on the Joint Development Zone for oil exploration, Nigeria agreed to provide São Tomé and Príncipe with the revenue from the sale of a limited number of oil barrels per year.

[7] This is similar to having a fiscal rule that specifies that current expenditure must be financed by domestic revenue collection, thus limiting public sector financing to fund investment projects (the so called "Golden Rule"). There is an abundant literature on why unconstrained discretion over revenue and spending can erode public finances, given the generally strong pressure on expanding government expenditure and a reluctance to raise taxes to the extent necessary to fully finance public outlays.

wage bill explain, in large part, the increase in the fiscal deficits, increased spending on goods and services (mostly on utilities) also drove the deficit up.[8] Since 2005, these deficits have been mainly financed by the use of oil signature bonuses placed at the NOA, in line with the rules established by the Oil Revenue Management Law.

Figure 2. Sao Tome & Principe- Domestic Revenue and Current Expenditure
(in percent of GDP)



Source: Sao Tome and Principe authorities and IMF staff estimates.

D. Comparative Perspective

13. **International comparisons provide insight into the São Tomé and Príncipe's revenue collection effort and directions for future reforms** (Figures 3a, 3b, and 4). It is useful to consider two groups of comparators for São Tomé and Príncipe: a group of neighboring Sub-Saharan African countries and a group of island economies that perhaps resemble a more advanced São Tomé and Príncipe.[9] Compared to the first group of countries, in 2006, São Tomé and Príncipe's tax revenue (17.2 percent of GDP) is very close to the average for Sub-Saharan Africa (17.8 percent of GDP), and lower than the average for island economies (22.2 percent of GDP).

[8] These two spending categories alone use up about 86.1 percent of total domestic revenue in 2008.

[9] In a subsequent table (Table 3) a comparison of income per capita is presented.

Figure 3a. Tax Revenue in Sub-Saharan African Countries
(2006, Percent of GDP)

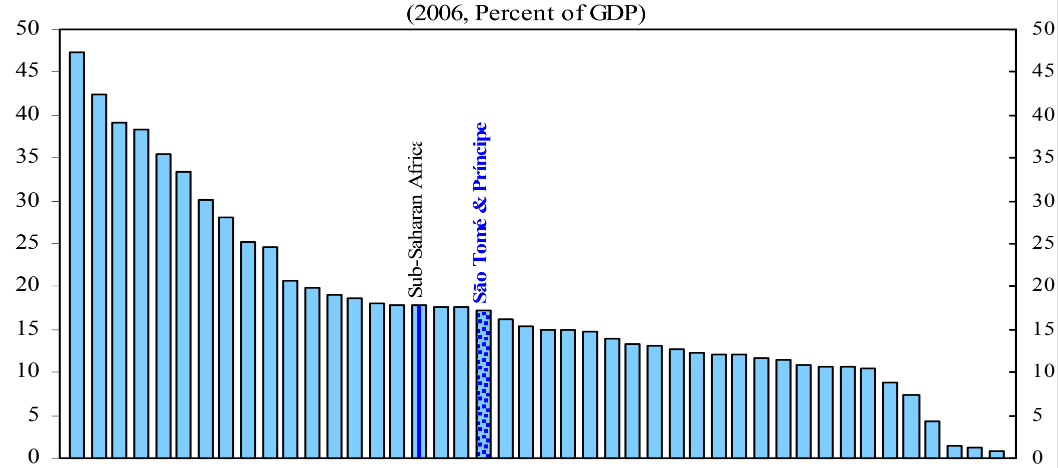
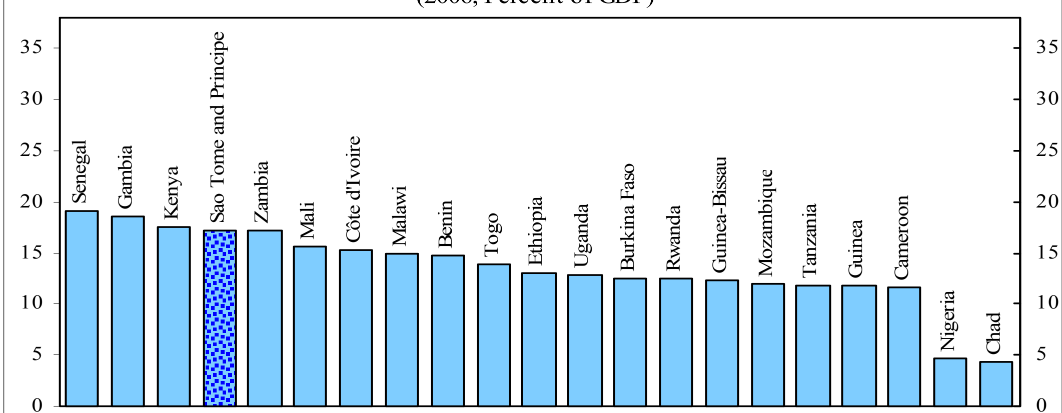
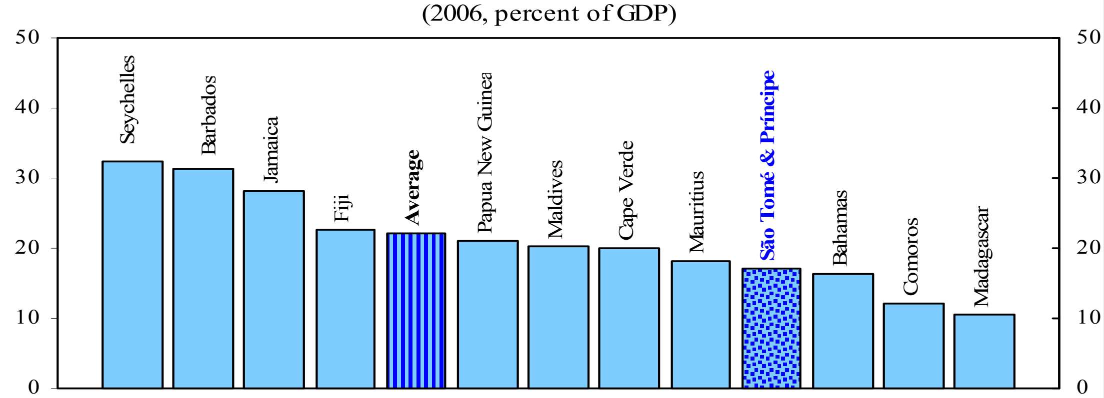


Figure 3b. Tax Revenue in Selected African Countries [1/]
(2006, Percent of GDP)



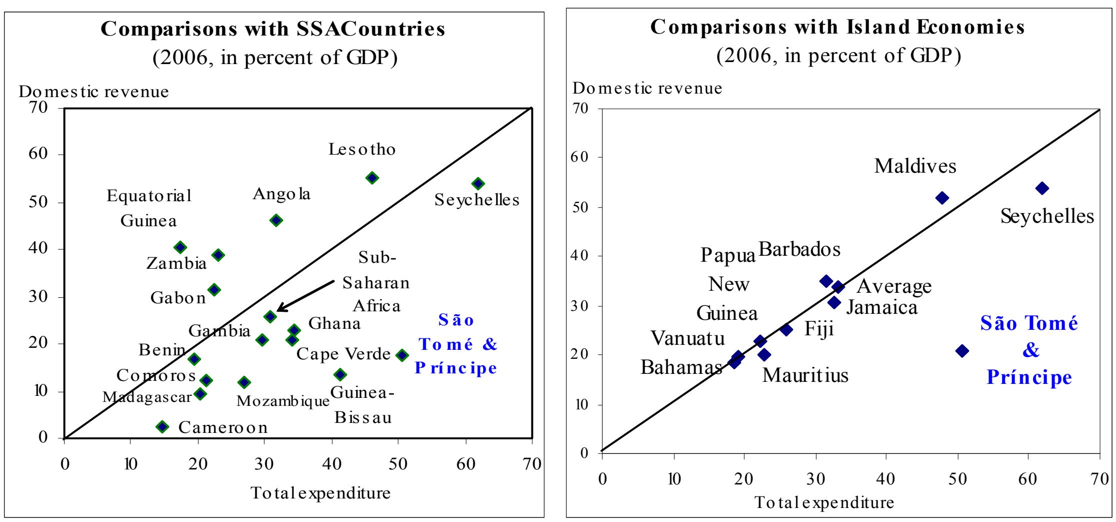
1/ Selected countries have similar levels of per capita income to Sao Tome and Principe - See Table 4.

Figure 4. Tax Revenue in Selected Island Economies
(2006, percent of GDP)



14. **São Tomé and Príncipe's increasing current public expenditures have persistently exceeded domestic revenues, leaving it as the outlier, compared with other countries** (Figure 5). Here, looking at domestic revenues and total expenditures in a number of countries can help assess the extent to which a country can meet spending pressures from domestic revenue sources. Total expenditure in percent of GDP is the second highest in São Tomé and Príncipe, compared to a selected group of African countries, and its domestic revenue is comparably small.[10, 11] Similarly, the country has the second highest level of total expenditure, though it fares better in terms of revenues, compared to selected, more diverse island economies.[12, 13]

Figure 5. São Tomé and Príncipe—Comparative Domestic Revenue and Total Expenditure



Sources: São Tomé and Príncipe authorities and IMF staff estimates.

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[10] Revenues in São Tomé and Príncipe exclude oil signature bonuses, since only a portion of these bonuses are available for budgetary use on an annual basis.

[11] Expenditures in the Seychelles are the highest in the selected group, but the country also has higher revenues to finance the higher expenditures.

[12] São Tomé and Príncipe also has a high risk of debt distress compared to 21 Sub-Saharan African countries that have low to medium risk, 7 countries with high risk, and 6 countries which are already in debt distress (out of 35 low-income countries with debt sustainability analyses).

[13] São Tomé and Príncipe also rates "weak" in the World Bank Country Policy and Institutional Assessment (CPIA) rating, which assesses the quality of a country's present policies and institutional framework in terms of fostering poverty reduction, sustainable growth, and the effective use of development assistance. There are 35 Sub-Saharan African countries in the rating, with 18 countries having strong and medium CPIA and 17 countries, including São Tomé and Príncipe, having week CPIA.

IV. Tax Potential—Statistical Evidence and Cross-Country Comparisons

15. **In looking at the performance of revenue, several economic characteristics need to be considered to judge the potential revenue for the country under study.** These include (i) per capita income (as an indicator of taxable income – the tax potential should increase with increases in income); (ii) the structure of output (some sectors are more difficult to tax than others and some sectors are generally tax exempt); and (iii) integration into the world economy (openness can increase the tax base, depending on the tariff structure and investment system). Such a cross-country analysis can help provide a benchmark of the amount of tax revenue that can be collected (defined here as tax potential), if the authorities were to make an average effort in tax collection, compared to the cross-country sample.

16. **Some interesting differences are revealed when comparing São Tomé and Príncipe's economic characteristics with Sub-Saharan African countries and with more economically diverse ones.** A simple look at the data in Table 3 reveals the following:

- *On income:* Although São Tomé and Príncipe's per capita income is high compared to many other poor countries in Sub-Saharan African (SSA), relative to the average, it earns less (expect higher tax revenue levels). Compared to island economies, São Tomé and Príncipe has one of the lowest per capita incomes (expect lower tax revenue levels).

- *On the structure of the economy:* Compared to SSA countries, agriculture value added in São Tomé and Príncipe is much lower than the average (expect higher tax revenue levels) and the country has much larger than the average services value added (expect higher tax revenue levels). Compared to island economies, São Tomé and Príncipe's agriculture and services sectors are closer to the average (expect similar levels of tax revenue).

- *On integration:* Compared to SSA countries, São Tomé and Príncipe has much higher than average imports of goods and services (expect higher tax revenue levels, though this depends on trade liberalization and tariff structure); and much higher than the average net FDI inflows (expect higher tax revenue levels, though this depends on tax incentives). Compared to island economies, São Tomé and Príncipe has much higher than the average imports and has received much higher than the average net FDI inflows (expect higher tax revenue levels).

Table 3. São Tomé & Príncipe and Selected Other Countries: Economic Characteristics, 2007 1/ 2/
(in percent of GDP, unless otherwise specified)

	Population (millions)	PPP Real GDP per capita (U.S. $)	Tax revenue	Output structure		Integration	
				Agriculture	Services	Imports of goods and services	Net FDI
São Tomé & Príncipe	**0.158**	**1,644**	**16.3**	**11.9**	**62.7**	**65.2**	**36.2**
African countries 3/							
Guinea-Bissau	1.69	473	12.3	63.6	24.2	46.5	4.7
Malawi	13.92	759	14.9	34.3	45.3	25.8	2.6
Togo	6.58	804	14.0	42.7	34.0	47.6	2.5
Ethiopia	79.09	807	13.0	46.3	40.3	32.2	2.5
Mozambique	21.37	843	11.9	28.3	45.1	46.2	5.3
Rwanda	9.74	936	12.5	35.6	50.0	27.7	2.4
Guinea	9.38	975	11.8	16.7	38.1	39.5	7.3
Uganda	30.93	1,066	12.9	29.0	52.8	32.0	5.8
Mali	12.33	1,074	15.7	36.5	39.1	37.0	2.3
Burkina Faso	14.78	1,207	12.5	33.3	44.4	26.8	5.1
Lesotho	2.01	1,254	44.3	11.9	41.2	99.8	6.3
Tanzania	40.43	1,256	11.9	45.3	37.3	27.8	3.9
Gambia, The	1.71	1,318	18.6	32.6	54.2	65.4	12.4
Zambia	11.92	1,323	17.2	21.6	40.2	35.8	11.6
Ghana	23.46	1,424	22.4	36.3	38.4	59.3	5.7
Benin	9.03	1,544	14.8	32.2	54.4	26.1	5.9
Côte d'Ivoire	19.27	1,616	15.2	23.4	50.5	40.7	2.2
Chad	10.76	1,669	4.3	23.4	32.5	33.9	10.1
Kenya	37.53	1,673	17.5	22.7	58.2	33.2	3.6
Senegal	12.41	1,698	19.2	14.7	63.2	42.7	2.7
Nigeria	147.98	2,038	4.6	32.5	28.0	29.9	3.6
Cameroon	18.53	2,094	11.6	19.4	51.6	21.3	2.6
SSA Average		*2,827*	*18.0*	*27.7*	*41.7*	*41.8*	*5.3*
Island economies							
Madagascar	19.67	934	10.7	26.5	58.4	44.0	10.1
Comoros	0.63	1,143	12.1	47.0	38.0	38.7	1.6
Papua New Guinea	6.06	2,168	21.0	35.7	19.1	69.1	0.6
Cape Verde	0.53	3,314	21.2	8.6	74.9	55.1	8.8
Vanuatu	0.23	3,489	18.3	14.7	76.7	57.8	10.5
Fiji	0.87	4,190	22.7	15.0	59.2	67.1	5.0
Maldives	0.34	5,036	23.8	11.2	…	76.7	1.5
Jamaica	2.69	6,099	29.2	6.4	59.6	62.1	8.8
Barbados	0.27	8,080	31.6	3.7	78.3	63.9	2.0
Mauritius	1.26	11,106	18.2	5.0	69.8	71.0	3.2
St. Kitts and Nevis	0.05	12,722	23.9	2.9	70.1	67.3	40.9
Seychelles	0.09	21,350	32.4	3.0	68.6	180.4	24.6
Average		*6,636*	*22.1*	*15.0*	*61.2*	*71.1*	*9.8*

Source: IMF and World Bank databases.
1/ See Appendix I for a full list of countries.
2/ Some data points refer to 2005 or 2006.
3/ Excluding island economies.

17. **Overall, a simple comparative look at the data for a selected group of countries shows that São Tomé and Príncipe collects less tax revenue, despite some characteristics that should result in higher tax revenues.** While the country's characteristics point to a higher tax potential than a number of neighboring African economies with relatively similar levels of development, on average, São Tomé and Príncipe's tax revenue fares somewhat worse. This is despite its larger service sector, a more open economy, and a smaller agriculture sector. Similarly, compared to the second group of countries – the more diverse island economies, which perhaps demonstrate the unfulfilled potential available to São Tomé and Príncipe, the country again fares worse in terms of tax revenue. São Tomé and Príncipe's higher agriculture production and its high

openness (significantly large share of imports in the economy) reflect the narrow productive base in the economy, which, in turn, depresses its tax base. At the same time, however, the country's openness has also been partly encouraged by trade liberalization reforms, which brought down custom tariffs to a simple average of 11.6 percent, which is lower than the SSA average of 12.7 percent. This liberalization could partly explain the lower tax revenues in São Tomé and Príncipe, compared to the more restrictive trade systems. Nonetheless, as discussed above, the relative underperformance of São Tomé and Príncipe's tax revenue also highlights the cost of weak tax compliance, exemptions, and weak tax administration, as well as the country' narrow productive base.

18. **Empirical analysis also shows that São Tomé and Príncipe's current tax performance seems to below potential.** Cross-country analysis using tax revenue, per capita GDP, the size of the agriculture sector, and imports helped identify the country's tax potential and revealed the scope available to boost tax revenue. The following equation was used for a cross section of 38 countries in 2007: [14]

$$Tax_{it} = \alpha_{it} + \beta\, pcGDP_{it} + \delta agr_{it} + \gamma\, imp_{it} + \nu_{it}$$

were "Tax" is the ratio of tax revenue to GDP; "pcGDP" is the change in PPP per capita GDP; "agri" is the ratio of the agriculture output to GDP; "imp" is the ratio of imports of goods and services to GDP; and "services" is the ratio of the service sector value added to GDP.[15]

19. **Empirical results from the model used above support the view that there is room for improving São Tomé and Príncipe's tax system**. The results show that the country's 2007 tax-revenue-to-GDP ratio of 16.3 percent is below the potential of 28.3 percent implied by the model (Tables 4 and 5, and Appendix I for full results of the model).[16] The following equation shows that the most important source of tax revenue, according to the results of the model, is from taxes on imports.

$$Tax_{it} = 1.7769 + \underset{(0.933)}{0.0114\, pcGDP_{it}} - \underset{(4.090)}{0.1812\, agr_{it}} + \underset{(4.957)}{0.3998\, imp_{it}} + \nu_{it}$$

[14] See Appendix I for details of the data set and the full results of all the models used.

[15] See similar cross-section studies in Josz (2007), Davoodi and Grigorian (2007), and Bird et al (2004).

[16] The full results of the model, shown in Appendix I, indicate that São Tomé and Príncipe's tax potential could range from 20.4 to 36.4 percent. As such, this study should be considered only as indicative of the room available to increase domestic resources, rather than a benchmark for the optimal level of tax potential for São Tomé and Príncipe, since factors such as tax incentives, tariff rates, and tax administration issues are not taken into consideration in the model.

This is an expected result, as discussed above, given the extent of São Tomé and Príncipe's openness, and dependence on import taxes as the main source of tax revenue. The cross-section empirical analysis also shows that the gap between São Tomé and Príncipe's actual revenue performance and the potential revenue performance in 2007 is highest among both neighboring African countries and island economies analyzed in the model (Figure 6).[17]

20. **The empirical results on tax potential presented in this model are broadly consistent with one of the objectives of São Tomé and Príncipe's poverty reduction strategy.** The 2006 PRSP, calls for an increase in tax revenue as a percent of GDP to 25 percent by 2010 and to 30 percent by 2015.[18]

Table 4. Cross-Section Analysis of Tax Potential

Dependent Variable: Tax revenue in percent of GDP
Included observations: 38

Variable	Coefficient	Std. Error	t-Statistic	Prob.	
Imports of goods and services (% of GDP)	0.39981	0.08065	4.95729	0.0000	*
Agriculture output (% of GDP)	-0.18122	0.04431	-4.09018	0.0002	*
PPP per capita, growth	0.01144	0.01226	0.93337	0.3572	
Constant	1.77687	0.36185	4.91049	0.0000	
R-squared	0.56138				
Adjusted R-squared	0.52268				
S.E. of regression	0.25560				
Prob(F-statistic)	0.00000				

See Appendix I for full details.
* denotes statistical significance at the 5 percent level.

Table 5. Comparative Analysis of Tax Potential - Selected Countries
(2007, in percent of GDP, unless otherwise indicated)

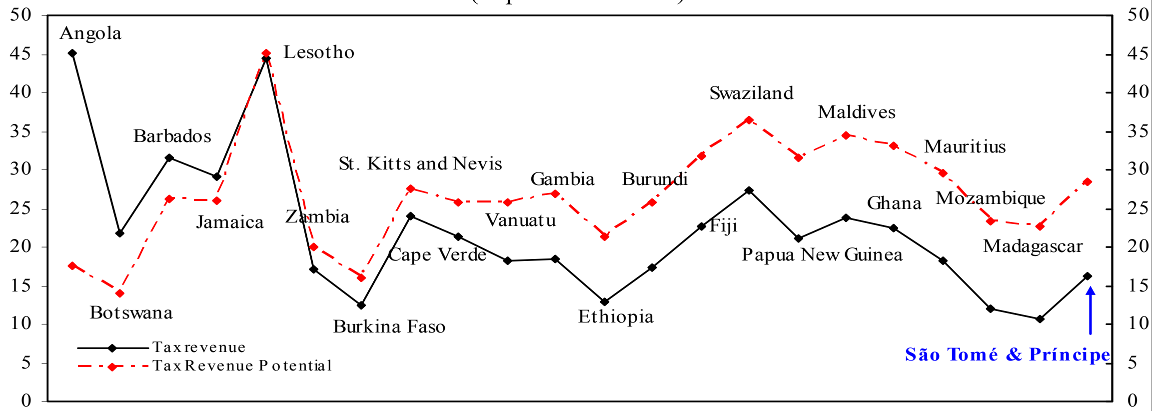
	Tax revenue	Imports of goods & services	Agriculture Production	PPP Real GDP per capita, growth	Tax Revenue Potential	Actual Tax minus Potential
São Tomé & Príncipe	**16.3**	**65.2**	**11.9**	**10.5**	**28.3**	**-12.0**
African countries						
Burkina Faso	12.5	24.8	33.3	4.0	16.0	-3.5
Gambia	18.6	52.3	32.6	6.4	26.9	-8.4
Mozambique	11.9	45.5	28.3	7.7	23.4	-11.5
Ghana	22.4	66.3	36.3	6.4	33.2	-10.8
Island economies						
Cape Verde	21.2	60.1	8.6	7.8	25.7	-4.4
St. Kitts and Nevis	23.9	67.3	2.9	3.8	27.5	-3.5
Mauritius	18.2	71.8	5.0	6.4	29.7	-11.5
Madagascar	10.7	44.6	26.5	6.4	22.7	-12.0

Sources: IMF and World Bank databases.
See Appendix I for full details.

[17] Madagascar and São Tomé and Príncipe both have the largest gap between actual revenue performance and the potential revenue performance (at 12 percentage points).

[18] The PRSP was finalized in 2003 and discussed at the IMF's Executive Board in 2006. See IMF Country Report No. 05/332 of September 2005.

Figure 6. Comparative Actual Tax Revenue and Tax Potential - Selected Countries
(in percent of GDP)



21. **It must be noted here that this result of a high tax potential for São Tomé and Príncipe should be interpreted as indicative of some of the room available for improving the tax-to-GDP ratio.** As discussed earlier, the result partly reflects São Tomé and Príncipe's current economic structure of a small agricultural sector and high dependence on imports. The results also reflect a narrow tax base (small productive base), and the weaknesses in the country's tax administration, including noncompliance, and weak collection and enforcement, due to the prevailing tax legislative structure during the period of study. In addition, a number of large enterprises, including hotels, enjoy significant tax incentives and holidays.

V. Recent Tax Reforms in São Tomé and Príncipe

22. **On the tax administration side, the authorities passed new tax laws at the end of 2008 that should improve the tax system when fully implemented.** Up to 2008, the income tax system in São Tomé and Príncipe was governed by tax laws and regulations dating back to 1993. Other taxes, such as the urban tax, were governed by laws and regulations dating back to 1898 and 1954. Indirect taxes are governed by laws dating back to 1976 and 1993. All these laws suffer from cumbersome evaluation and collection rules, special exemptions, and limited taxpayer protection. At the same time, the tax directorate's operations for tax registration, taxpayer assistance, and data input operations are all mostly manual. The administration's capacity to conduct tax enforcement activities remains extremely limited, reflecting shortage of trained staff, limited information sources, and weak ability to conduct tax audits or collection activity.[19] Both the outdated and inefficient

[19] The audit function has limited personnel. There are no existing written procedures or guidelines for use by the audit staff. There is no systematic approach used to conduct the audits or prepare the audit documentation. Selection of taxpayers for audit is accomplished by a small committee using their experience and knowledge. An average of 15–20 cases per year have been audited over the years.

tax laws and the weaknesses in the tax administration were behind the unsatisfactory performance of direct taxes during the period 2001-2008, as discussed above. More specifically, the high corporate tax rate, at 45 percent, may have created an environment of tax evasion and acted as a deterrent to business, thus contributing to a low tax base. Similarly, the weak tax administration has also contributed to an ineffectual tax environment, resulting in low enforcement, which exasperated the existing low tax moral, and resulted in mounting tax arrears.[20, 21] Such weaknesses have been reflected in the 2009 Ease of Paying Taxes indicators from the 2009 World Bank Doing Business Report, which ranks countries in an indicator (the ease of paying taxes) that reflects the tax burden, the time to comply, and the number of tax payments made. Out of 181 countries, São Tomé and Príncipe ranked 151,[22] mainly due to a low ranking on the time to comply and the number of tax payments made (see Appendix IV).

23. **The new income tax laws were approved by the National Assembly in late 2008, and should be in force in from April 2009.** The new laws aim to modernize and simplify the tax system, thus encouraging tax compliance, and put in place a more equitable tax framework. As discussed above, once the laws are implemented, the personal income tax rates will range between zero (for the threshold of exemption) and 20 percent, while the corporate tax rate will be unified at 25 percent (Appendix II).

24. **At the same time, as part of the country's Threshold Program with the Millennium Challenge Corporation (MCC), efforts are underway to improve the revenue administration**. The authorities are working with the MCC to improve processes and automation, including tax registration, returns processing, audit, taxpayer accounting, and revenue accounting.[23] In addition, though legislation effective since August 2007 placed the authority for enforced collection with a Tax Tribunal[24], which is not yet established, tax collection is slowly improving. The authorities, with help from the MCC, are putting in place an enforced collection plan, which has begun collection of at least 50 cases, though

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[20] It is estimated that only 35–40 % of businesses are actually tax registered and an even lower percentage is filing and paying taxes. This is due to both weaknesses in the tax administration side, where enforcement is week, and the weak voluntary tax compliance

[21] The weak tax enforcement has resulted in a significant stock of tax arrears of about 132 billion dobra by September 2008. For reference, this stock of arrears is equivalent to 35 percent of tax revenue in 2008 alone and 5.1 percent of GDP.

[22] Countries that rank highly on the ease of paying taxes (closer to a ranking of 1) tend to have lower and less complex taxes with simple administrative processes for paying taxes and filing tax returns.

[23] Portugal also provides extensive technical assistance to help improve the revenue administration.

[24] The Code of Tax Processes and Procedures created a Tax Tribunal to hear taxpayer appeals and to take enforced collection action. The law was enacted in December 2006 and became effective in August 2007. An Organic Law is required for the actual creation of the Tribunal.

none of which are large tax payers. On tax arrears, the National Assembly is considering a tax pardon law for tax years through 2006. By providing an amnesty for past-due taxes and putting in place measures that could enable deferred tax payments, the authorities are of the view that the tax pardon law can help create the conditions for an effective national tax system. Although the introduction of tax debt deferrals is a good move toward international best practices in tax laws, providing a full tax amnesty for some tax payers, as noted in the proposed law, is not considered to be good international practice, particularly since the current broad proposal for the amnesty will result in an unfair tax treatment.[25] Overall, until such time that the Tax Tribunal becomes fully operational, and in order to improve tax collection and enforcement, the authority of the Directorate of Taxes should be enhanced, including increased monitoring of large taxpayers. In addition, a comprehensive fiscal procedures code may be necessary to create a consistent set of comprehensive tax administration procedures.

25. **On the customs' administration side, inspection and enforcement is limited by the lack of basic equipment and transportation difficulties.** The customs' administration uses the 1994 UNCTAD ASYCUDA system, which is outdated with obsolete software that is no longer supported by UNCTAD. The MCC has made an initial procurement for a new ASYCUDA system for Customs and are working with the authorities to develop improved automated processes. While evasion of customs' duties is not a significant problem, mainly due to low tariffs, control of smuggling is hampered by the lack of access to entry points beyond the airport and the seaport. Moreover, delays in customs' clearance procedures reflect weak communication within the customs department and lack of transportation and inspection equipment.[26]

26. **In 2001, the authorities implemented a number of trade policy reforms to simplify the system and remove distortions.** Export taxes and non-tariff barriers were eliminated. The tariff system was simplified with the introduction of four basic rates (zero, 5, 10, and 20 percent).[27] This lowered the average tariff rate from 20 percent to 11.7 percent, which is substantially lower than neighboring countries, placing São Tomé and Príncipe among countries with highly open trade systems. In 2007, the Council of

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[25] Without a clear and credible commitment to administrative reforms, an amnesty may serve as a signal of weak enforcement capacity of the tax administration, with adverse revenue consequences during and after the amnesty. A number of studies on the impact of one-shot and intermittent amnesties have shown negative revenue effects. Moreover, tax amnesties can be can result in unfair tax treatments, as they pardon tax evaders at the expense of voluntarily compliant taxpayers. See Torgler, Schaltegger (2005), Baer, Le Borgne (2008), and Bird (2003).

[26] At the seaport, customs' inspectors must wait for a ship to send a boat ashore for them or ride on a fisherman's boat to conduct inspections. Moreover, due to a lack of imaging equipment, all containers are completely unpacked for inspection.

[27] There are currently three tariff bands, down from more than 100 bands.

Ministers approved a new Customs law, which updates and modernizes the customs' system. In addition, the authorities have prepared new customs codes that are currently under expert review by the MCC.

VI. Tax Policy Reforms—Recommendations Going Forward

27. **Given the challenges facing São Tomé and Príncipe, including uncertain oil prospects and rising demands to invest in development and reduce poverty, the need for increasing domestic revenue resources is clear.** After much delay, new drilling for oil is expected in late 2009, pushing the prospects for possible oil production, if commercially viable amounts are found, beyond 2014. Despite this uncertainty, public expenditures (particularly current spending) have been increasing since 2004 by an average of 30 percent per year, in anticipation of oil revenues. In addition, the country's developmental needs are large, particularly in the areas of infrastructure, health, education, and poverty reduction, thus adding to the pressure on government expenditure. In this regard, one of the objectives of the country's PRSP is to boost government revenue and improve the environment for private enterprise to help achieve "fiscal discipline and reduce the threat of inflation resulting from the scarcity of financial resources". In the PRSP, the authorities committed to increasing revenue by simplifying the tax system and limiting exemptions.

28. **Whether São Tomé and Príncipe becomes an oil producer or not, building a solid non-oil revenue base—less volatile and exhaustible than a natural resource—to finance public expenditures should be viewed as an essential component of sound fiscal management.** As demonstrated earlier, a number of reforms have been introduced in recent years, but the domestic revenue base remains thin relative to the increasing expenditure needs and to the revenue potential. In addition, the country clearly depends on trade taxes, both custom tariffs and excise duties, including on imported petroleum products. Given the high volatility and uncertainty in international oil prices, such a dependency is increasing the economy's vulnerability, rather than improving its sustainability. Though a move toward an efficient and reliable indirect tax system would generally generate more tax revenue than a reliance on a direct tax system, this is not yet the case of São Tomé and Príncipe. This is since a more sustainable indirect tax system would rely on more complex taxes, such as Value Added Taxes (VAT). Such taxes require a more sophisticated and efficient tax administration, which the country still does not have. In addition, indirect taxes are generally regressive by nature and can increase inequity given the higher marginal propensity to consume of low income groups. By contrast, direct taxes tend to grow with income and enhance revenue buoyancy and can therefore be more dependable.

29. **Accordingly, tax reforms (both direct and indirect) and structural measures to increase revenue and expand the economy's productive base will be critical to**

ensuring medium-term fiscal sustainability, regardless of future oil prospects. Priority adjustment and reforms in the period ahead could include the following:

- **Swift implementation of the new tax laws.** These laws aim at modernizing the tax system, broadening the tax base, and reducing distortions, thus increasing tax revenue over time, mostly through efficiency gains.

- **Strengthened tax and customs administration**. In essence, it is thought that "tax administration is tax policy".[28] Initial measures should focus on increasing administrative capacity, including enforcement of tax collection. Over time, measures are needed to ensure a system that relies on voluntary compliance, self assessment, and audits.

- **Reduction of tax exemptions.** Direct and indirect tax exemptions to special sectors should be reduced to the minimum. While this measure requires political will, its implementation can expand the tax net and raise tax revenue while improving the neutrality of the tax system and increasing economic efficiency.

- **Changing the structure of excise taxes.** As discussed above and in Appendix III, there is a very wide range of products that are subject to excise taxes (currently more than 100 products at many varying rates). Some improvements can help increase the efficiency and simplicity of excise taxes, including confining taxes to the traditional goods subject to excises – tobacco, alcohol, petroleum products and a limited number of luxury goods, and linking their design to associated externalities (social and environmental costs) – higher taxes on products with more inelastic demand and higher negative externalities.[29] At the same time, the tax rate should be unified for domestically produced and imported goods, in order to remove the resulting implicit tariff protection. The excise tax on services can be increased from its current rate of 5 percent to a rate of 10 percent (on the low-side for cost recovery). This reform can be implemented gradually over the next three years and can pave the way for the future introduction of additional indirect taxes, such as a sales tax.

- **Over time, introduce a sales tax to replace the excise tax on a number of products.** There are a large number of products, such as mineral water, soft drinks, olive oil, and small cars (see Appendix III), that should not be subject to an excise tax but could instead be subject to a sales tax. As the tax administration in São

[28] Improving Tax Administration in Developing Countries, IMF 1990.

[29] Gupta and Mahler (1994); Bolnick and Haughton (1998); Bacon (2001); Hossain (2003); and Hines (2007).

Tomé and Príncipe improves with time, the authorities can gradually move to introducing a sales tax, such as a GST or a VAT.

- **Eliminate a number of other small taxes**. There are a large number of cumbersome and universal stamp duties, along with other small taxes, that yield little revenue, as discussed above (also see Appendix III). These taxes are expensive to administer and cause significant inconvenience to taxpayers.[30] Eliminating the majority of these taxes could help simplify the tax system, clear administrative resources for more productive uses, ease the tax burden on the payer, and reduce tax evasion.

30. **The above tax reforms should be part of a more comprehensive policy to achieve fiscal consolidation**, **preserve macroeconomic stability, and develop the country's productive base.** A comprehensive fiscal strategy, based on both revenue and expenditure measures, including improvements in tax administration and public expenditure management, is needed. This would include the above tax reform measures, as well as expenditure restraint, to result in a sustainable use of available use of domestic resources. Moreover, to support the revenue efforts, structural reforms are needed to improve the country's infrastructure and lay the basis for private sector development, to help expand the revenue base in a more sustainable manner over the long run.[31]

31. **São Tomé and Príncipe's development partners continue to support the authorities.** The IMF and the World Bank provide technical assistance and policy advice, along with the support provided by the threshold program provided by the Millennium Challenge Corporation. The European Union (EU) provides project support and technical advice. In addition, in due course, cooperation through the EU's Economic Partnership Agreement and membership in the World Trade Organization can help support the country's development efforts through improved governance, social development, and capacity building, in addition to greater integration and broader access to markets.

VII. Summary and Conclusions

32. **São Tomé and Príncipe's openness and dependence on imports results in a high dependence on indirect taxes as the main source of domestic revenue.** The country is very open and highly depends on imports resulting in high indirect tax revenue, which is

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[30] For example, stamp duties are required on all forms, including school registration forms for children.

[31] Structural reforms to boost private sector activity include legislative reforms to reduce the administrative burden on businesses and labor market reforms to increase flexibility. The country will also highly benefit from significantly improving basic infrastructure, including roads, ports, and utility provision. Such improvements will not only be beneficial for business, but also can help develop the still small yet highly promising tourism sector.

volatile. At the same time, the production and export base are very narrow, leaving the authorities with a small tax base. For these reasons, along with capacity constraints at the tax administration, São Tomé and Príncipe's tax performance compares relatively unfavorably with neighboring countries and other island economies.

33. **The authorities need to mobilize sufficient domestic resources to meet the country's development and social objectives, regardless of future oil prospects.** Given the challenges facing São Tomé and Príncipe, the need for increasing domestic revenue resources is clear. Despite efforts to strengthen fiscal prudence, increasing current public expenditures have persistently exceeded domestic revenues. At the same time, however, additional revenue resources from oil are uncertain. Drilling for oil has been delayed further, possibly pushing the prospects for oil production, if commercially viable amounts are found, beyond 2014.

34. **In addition, São Tomé and Príncipe's revenue collection is not very efficient.** The country's tax efficiency has been relatively low and tax arrears are significant. Despite genuine efforts by the authorities to reform, the tax system remains outdated and complex. Such a system has not been conducive to creating good tax morale, both on the tax administrators' and the tax payers' side.

35. **Cross-country empirical analysis shows that São Tomé and Príncipe's current tax performance seems to be below potential.** The country fares much worse than the performance of its neighboring countries and other island economies, pointing to weaknesses in tax administration as well as a less diversified and smaller tax base.

36. **Accordingly, a comprehensive fiscal strategy, based on both fiscal consolidation through revenue and expenditure measures, is needed.** Whether São Tomé and Príncipe becomes an oil producer or not, it is more sustainable for it to rely on non-oil revenues—a less volatile and less exhaustible resource—to finance current expenditures. A number of measures are needed to improve the tax structure, strengthen the effectiveness of the tax administration, and enhance tax compliance. The fiscal adjustment and reform measures should be accompanied by a focused strategy to expand the country's productive base to ensure sustainability over the long run. Maintaining the momentum of reform will be critical for achieving meaningful and sustainable results.

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Appendix I
Empirical Analysis

1. **In looking at the performance of revenue, several economic characteristics need to be considered to judge the potential revenue for the country under study.** These include: (i) per capita income (as an indicator of taxable income); (ii) the structure of output (some sectors are more difficult to tax than others and some sectors are generally tax exempt); and (iii) integration into the world economy (openness can increase the tax base). Such a cross-country analysis can help provide a benchmark of the amount of tax revenue that can be collected (defined here as tax potential) in São Tomé and Príncipe, if the authorities were to make an average effort in tax collection, compared to the cross-country sample.

2. **The empirical model used in this paper builds on the above characteristics to study whether São Tomé and Príncipe's current tax performance is below potential.** Cross-country analysis using tax revenue, change in per capita GDP, the size of the agriculture sector, and imports helped identify the country's tax potential and revealed the scope available to boost tax revenue. The following equation was used for a cross section of 38 countries in 2007: [32]

$$Tax_{it} = \alpha_{it} + \beta\, pcGDP_{it} + \delta\, agr_{it} + \gamma\, imp_{it} + \nu_{it}$$

were "Tax" is the ratio of tax revenue to GDP; "pcGDP" is the change in PPP per capita GDP; "agri" is the ratio of the agriculture output to GDP; and "imp" is the ratio of imports of goods and services to GDP. The model used was tested using an ordinary least squares.

3. **Empirical results from the model used above support the view that there is room for improving São Tomé and Príncipe's tax system**.[33] The results show that the country's 2007 tax-revenue-to-GDP ratio of 16.3 percent is below the potential of 28.3 percent implied by the model (Tables I.1 and I.2). The cross-section empirical analysis shows that the level of openness (value added of imports) and the structure of the economy (value added of agriculture) have a significant effect on the country's tax potential at the 5 percent confidence interval. At the same time, however, the change in per capita income does not significantly contribute to tax potential. All the indicators in the model have the expected signs, as follows:

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[32] The model was run with up to 65 countries. See below for results.

[33] The results of the model should be considered only as indicative of the room available to increase domestic resources, rather than a benchmark for the optimal level of tax potential for São Tomé and Príncipe, since factors such as tax incentives, tariff rates, and tax administration issues are not taken into consideration in the model.

$$Tax_{it} = 1.7769 + 0.0114\,pcGDP_{it} - 0.1812\,agr_{it} + 0.3998\,imp_{it} + \nu_{it}$$
$$(0.933) \qquad (4.090) \qquad (4.957)$$

Table I.1. Cross-Section Analysis of Tax Potential

Dependent Variable: Tax revenue in percent of GDP
Included observations: 38

Variable	Coefficient	Std. Error	t-Statistic	Prob.	
Imports of goods and services (% of GDP)	0.399805	0.08065	4.957292	0.0000	*
Agriculture output (% of GDP)	-0.181222	0.044307	-4.09018	0.0002	*
PPP per capita, change	0.011444	0.012261	0.933365	0.3572	
Constant	1.77687	0.361852	4.91049	0.0000	
R-squared	0.561381				
Adjusted R-squared	0.522679				
S.E. of regression	0.255601				
Prob(F-statistic)	0.000003				

* denotes statistical significance at the 5 percent level.

Table I.2 Cross-Section Analysis of Tax Potential

(2007, in percent of GDP, unless otherwise indicated) 1/

	Tax revenue	Imports of goods and services	Agriculture output	PPP Real GDP per capita (% change)	Tax Revenue Potential	Actual Tax minus Potential
Angola	45.2	39.0	9.9	20.8	17.6	27.5
Australia	25.4	21.8	3.1	5.3	9.3	16.1
South Africa	29.0	34.0	2.7	6.9	14.2	14.9
Denmark	31.2	49.0	1.6	3.9	19.9	11.2
Botswana	21.7	33.7	1.9	9.5	13.9	7.8
Turkey	19.7	27.0	8.9	6.2	12.5	7.2
Brazil	11.3	10.7	4.9	6.8	5.2	6.1
Barbados	31.6	63.9	3.7	5.7	26.3	5.3
Argentina	14.2	19.2	8.4	10.5	9.3	4.9
Peru	13.5	19.5	6.3	10.1	9.0	4.5
Jamaica	29.2	62.1	6.4	3.4	26.0	3.2
Poland	17.3	41.6	4.3	9.6	17.5	-0.2
Lesotho	44.3	107.0	11.9	5.8	45.0	-0.7
Ireland	26.7	68.6	2.1	6.4	27.9	-1.2
India	10.7	24.4	17.8	10.6	13.1	-2.4
Egypt	15.5	39.2	13.0	7.8	18.1	-2.6
Armenia	14.4	33.8	18.3	14.3	17.0	-2.6
Zambia	17.2	39.8	21.6	6.6	19.9	-2.8
Tunisia	19.8	52.2	10.9	8.1	22.9	-3.2
St. Kitts and Nevis	23.9	67.3	2.9	3.8	27.5	-3.5
Burkina Faso	12.5	24.8	33.3	4.0	16.0	-3.5
Cape Verde	21.2	60.1	8.6	7.8	25.7	-4.4
Vanuatu	18.3	57.8	14.7	6.6	25.8	-7.5
Albania	17.3	53.5	22.8	8.3	25.6	-8.3
Gambia	18.6	52.3	32.6	6.4	26.9	-8.4
Burundi	17.2	48.4	34.8	4.3	25.7	-8.5
Fiji	22.7	72.6	15.0	-1.3	31.7	-9.0
Swaziland	27.2	87.2	8.1	5.9	36.4	-9.1
Ethiopia	13.0	32.2	46.3	11.3	21.4	-8.4
Mozambique	11.9	45.5	28.3	7.7	23.4	-11.5
Papua New Guinea	21.0	62.8	35.7	6.6	31.6	-10.6
Maldives	23.8	80.8	11.2	10.5	34.4	-10.7
Ghana	22.4	66.3	36.3	6.4	33.2	-10.8
Mauritius	18.2	71.8	5.0	6.4	29.7	-11.5
Jordan	26.2	92.9	3.1	6.5	37.8	-11.6
Madagascar	10.7	44.6	26.5	6.4	22.7	-12.0
São Tomé & Príncipe	**16.3**	**65.2**	**11.9**	**10.5**	**28.3**	**-12.0**

Source: IMF and World Bank database.

1/ Despite weaknesses in the data (year understudy varies for some countries), the model was checked for robustness by removing the unbalanced countries. The results were very similar to the above.

4. **The model was also tested for robustness as follows:**

- **Adding dummies:** Two dummy variables were added for island economies and oil-producing countries. The results for the main economic indictors remain roughly the same as the original model: imports and agriculture value added are significant determinants of tax revenues—with a larger impact of imports on tax revenue potential, while the change in GDP per capita does not have a significant effect on tax revenues. The model shows that if a country is an oil producing economy, then its potential tax revenue would be positively affected. However, being an Island economy does not have a significant effect on tax potential (Table I.3). Therefore, the results show that São Tomé and Príncipe's tax potential rises to 36.4 percent from 28.3 percent, mostly due to the increasing importance of imports.

Table I.3. Cross-Section Analysis of Tax Potential

Dependent Variable: Tax revenue in percent of GDP
Included observations: 38

Variable	Coefficient	Std. Error	t-Statistic	Prob.	
Imports of goods and services (% of GDP)	0.534095	0.089497	5.967764	0.0000	*
Agriculture output (% of GDP)	-0.141616	0.045709	-3.098219	0.0040	*
PPP per capita, change	0.003911	0.011719	0.333700	0.7408	
Dummy - Island economy	-0.111720	0.091860	-1.216202	0.2328	
Dummy - Oil-producing economies	0.265687	0.103706	2.561925	0.0153	*
Constant	1.191580	0.395252	3.014736	0.0050	
R-squared	0.648156				
Adjusted R-squared	0.593180				
S.E. of regression	0.235971				
Prob(F-statistic)	0.000002				

* denotes statistical significance at the 5 percent level.

- **Using a larger sample set:** The size of the sample was increased from 38 countries to 56 countries. Like the original model, imports and agriculture value added remain significant determinants of tax revenues, however, the change in GDP per capita also becomes a significant determinant of tax potential but changes signs to negative (an increase in income results in lower taxes). Moreover, the role of the dummy variable changes; being an island economy significantly and negatively affects tax potential, while being an oil economy does not (Table I.4). Consequently, the results show that São Tomé and Príncipe's tax potential falls to 20.4 percent, mostly due to the negative impact of per capita income.

Table I.4. Cross-Section Analysis of Tax Potential

Dependent Variable: Tax revenue in percent of GDP
Method: Least Squares
Included observations: 56

Variable	Coefficient	Std. Error	t-Statistic	Prob.	
Imports of goods and services (% of GDP)	0.451666	0.078396	5.761341	0.00000	*
Agriculture output (% of GDP)	-0.218150	0.041517	-5.254507	0.00000	*
PPP per capita, change	-0.017840	0.008279	-2.154844	0.03600	*
Dummy - Island economy	-0.176782	0.079950	-2.211148	0.03160	*
Dummy - Oil-producing economies	0.073523	0.091622	0.802458	0.42610	
C	1.909136	0.381087	5.009706	0.00000	
R-squared	0.692997				
Adjusted R-squared	0.662297				
S.E. of regression	0.220880				
Prob (F-statistic)	0.000000				

* denotes statistical significance at the 5 percent level.

- **Using GNP:** Replacing per capita GDP with a wider concept of income, Gross National Product (GNP), did not significantly change the results. Like the original model, imports and agriculture value added remain significant determinants of tax revenues, and the change in GDP per capita remains a significant determinant of tax potential but with a negative sign (an increase in income results in lower taxes). Moreover, the role of both dummy variables becomes significant. The results show that São Tomé and Príncipe's tax potential increases to 26.6 percent (Table I.4), due to smaller negative effects of agriculture.

Table I.4. Cross-Section Analysis of Tax Potential

Dependent Variable: Tax revenue in percent of GDP
Method: Least Squares
Included observations: 56

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Imports of goods and services (% of GDP)	0.442170	0.083505	5.295099	0.000000 *
Agriculture output (% of GDP)	-0.163297	0.037101	-4.401366	0.000100 *
GNP, change	-0.007676	0.003287	-2.335682	0.023600 *
Dummy - Island economy	-0.148345	0.083664	-1.773106	0.082300 **
Dummy - Oil-producing economies	0.197492	0.084179	2.346097	0.023000 *
C	1.797949	0.367158	4.896940	0.000000
R-squared	0.662974			
Adjusted R-squared	0.629271			
S.E. of regression	0.233967			
Prob (F-statistic)	0.000000			

* denotes statistical significance at the 5 percent level.
** denotes statistical significance at the 10 percent level.

5. **Overall, empirical results from all the models used above support the view that there is room for improving São Tomé and Príncipe's tax system**. The results show that the country's 2007 tax-revenue-to-GDP ratio of 16.3 percent is below the potential, which lies in the range of 20.4 to 36.4 percent (Table I.5). As such, this study should be considered only as indicative of the room available to increase domestic resources, rather than a benchmark for the optimal level of tax potential for São Tomé and Príncipe, since factors such as tax incentives, tariff rates, and tax administration issues are not taken into consideration in the model.

Table I.5. Sao Tome and Principe - Summary of Empirical Results on Tax Potential

Actual Tax Revenue, 2007 in % of GDP	38countries		56 countries	Using GNP
	Original Model	+ Dummy Variables		
16.3	28.3	36.4	20.4	26.6

APPENDIX II
SÃO TOMÉ AND PRÍNCIPE—SUMMARY OF TAX SYSTEM
DIRECT TAX LAWS —NEW AND OLD

New Law **Income Tax** (IRS) – See Law 17/08 for more details	**Old Law** **Income Tax** (IRS) – See Law 11/93 and Law 64/97 for more details
Nature of Tax Levied on all income for residents and nonresidents, in cash or in kind, from A. employment and pensions, B. business and professional income, C. capital income, and D. asset increases. Residents' income includes that earned abroad. For income from employment, the tax is withheld at source and payable by the 10th day of the month after the deduction. For all other income, declaration forms should be filed annually in February following the tax year. All taxes must be paid by September 30 of the year following the tax year. **Deductions** • Personal and family deductions: 20% of annual minimum wage for each taxpayer. 25% of annual minimum wage for each taxpayer with one (non-tax liable) dependent, 30% with two, and 35% with three or more. These deductions will increase to 50% for persons/families with disabilities. • Health expenses: 30% of all health-related expenses of the taxpayer and his/her household and descendants or relatives to the third degree (in the household earning less than minimum wage); and 30% of interest on debt related to health-related expenses -- not exceeding 1 million dobra, or 2.5 percent of the listed expenses. • Education expenses: 30% of all education/training-related expenses of the taxpayer and his/her household; and 30% of interest on debt related to education/training-related expenses – not exceeding 1 million dobra. • 30% of real property-related expenses not exceeding 15 million dobra, including maintenance, repair, and interest and principal of debt related to the acquisition and construction of owner-occupied housing. • Employee social security contributions, 50% of aggregate pension income, union dues, and international double taxation • Payments related to breach of employment contract, not exceeding the	**Nature of Tax** Levied on all resident and non-resident domestically earned income, in cash and in kind. The tax is withheld at source and payable within the first 8 days of the month after the income was earned. **Deductions and Exemptions** • Earned annual income up to 480,000 dobra after 5,000 dobra monthly deductible. • Salary supplements up to 10% of the fixed monthly salary. • Expense allowances and per diem and representation allowances up to the limits set for government employees. • Income of clergy from spiritual functions. • Foreign personnel of diplomatic and consular missions or in the service of international or foreign organizations. • Certain moving expenses. **Rates** Flat rate of 13%.

base pay for the required notice.

- All transport, travel, and per diem expenses not exceeding 10% of total taxable earnings.
- Deductible expenses related to a business in the taxpayer's resident, including depreciation, interest, rent, power, utility bills, use of own vehicle, meal allowances, etc. not exceeding 10% of total taxable earnings.
- Negative net earnings from business income may be deducted from positive net income over a period of 5 years.
- 50% of income from interests in equity (dividends, shares of corporate profits, advances on earnings, liquidation dividends) and profits from partnerships, shareholders, or associations.

Exemptions

- Mandatory employer social security contributions, pensions that are less than 24 million dobra per year, and severance pay
- Scholarships, government bursaries, with proof of enrollment (one per tax payer), services related to professional training, and benefits for social/leisure services and/or facilities.
- Staff of diplomatic and consular missions or working for international organizations.
- For tax payments on asset increases, any increases from the transfer of real property if the property is the primary residence for at least 5 years located in Saotomean territory

Rates

For income A, B, and D:

15 million dobra = 0 %

15 – 60 million dobra = 10% with 1.17 million deductible.

60 – 180 million dobra = 13% with 2.5 million deductible.

180 – 300 million dobra = 18% with 7.5 million deductible.

Above 300 million dobra = 20% with 12 million deductible.

For income A that is withheld at source:

15 – 60 million dobra = 8%.

60 – 180 million dobra = 11%.

180 – 300 million dobra = 16%.

15% flat tax on other gross income not specified by the law.

New Law **Corporate Tax** (IRC) – See Law 16/08 for more details	**Old Law** **Corporate Tax** (IRC) – See Law 9/93; Law 84/93; Law 46/93; Law 58/95; Law 40/96 for more details.
<u>Nature of Tax</u> Levied on commercial companies or noncommercial partnerships established as businesses, cooperatives, and public enterprises – not including the State, local governments, and the Autonomous region of Príncipe. The tax is assessed against earnings from commercial, industrial, or agricultural activity, even if occasional or temporary. Residents' income includes that obtained abroad. Non-residents only pay tax on their income earned in the territory. Self assessments must be submitted by August 31 of every year. Advanced payments of 25% of the assessed tax must be made in June, September, and December of the tax year. **<u>Exemptions</u>** • International organizations of which São Tomé and Príncipe is a member. • Religious organizations with independent legal status and non-profit organizations. • 50% of earnings of exclusive agricultural activity, after loss deductions. **<u>Deductions</u>** • 50% of travel grants and 50% of personal vehicle and passenger/cargo vehicle use (except those taxed under the IRS). • Representation expenses of no more than 2% of the volume of business (including 50% of refreshments, outings, etc.). • International double taxation. **<u>Rates</u>** A *general rate* of 25%. A rate of 20% for *income withheld at source*: income related to intellectual or industrial property rights; income from the use of agricultural, commercial, or scientific equipment; income from capital investments defined in the IRS; remuneration from statutory bodies; lottery/betting/gaming prize winnings; income from professional entertaining or sports; and income from work/services for a client in the territory.	**<u>Nature of Tax</u>** Levied on all domestic income from any commercial, industrial, service, or agricultural business or independent profession, even if occasional or temporary. The minimum tax (Law 58/95) is payable during the first half of the year by all commercial, industrial, and artisan businesses, and the self-employed. The minimum tax is deductible from the tax on profits and is ad volarem. **<u>Exemptions and Deductions</u>** • Profits from investment or dividends from mutual aid societies and nonprofit cooperatives. • 50% of profits from agricultural activities. • Special exemptions granted in the context of the investment code. **<u>Rates</u>** *For commercial, industrial, service, and agricultural businesses*: A flat rate of 30% rate on taxable profits, plus an additional 15% on taxable profits in excess of 12 million dobra. *For independent professionals:* A five-bracket schedule from 5 to 30% applies to taxable profits of 60,000 to 3 million dobra; A flat rate of 30% on taxable profits above 3 million dobra, plus a 15 % surcharge on the portion of taxable profits in excess of 3 million dobra.

Other Income Taxes:

1- Tax on income by taxis – See Law 36/00 for more details.

<u>Nature of Tax</u>

Levied on income from taxi services.

<u>Exemptions</u>

None.

<u>Rates</u>

Fixed rates depending on location and vehicle tonnage.

2- Taxes on property: Urban Property Tax – See Act 450 of 1954; Law 57/81; Law 16/93; Law 45/93; Law 84/93; Law 40/96 for more details.

<u>Nature of Tax</u>

Levied on all urban property, including permanent buildings intended for housing, commercial, or industrial purposes other than exploitation of land, and the land on which the buildings are located; and buildings for construction.

<u>Exemptions</u>

- Government properties.
- For two years, permanent buildings for use as dwellings by owners or their families, including buildings replacing demolished buildings, provided the construction period does not exceed 2 years.
- Owners of property whose total income does not exceed 2,000 dobra per day.
- All property owned by religious entities pursuing their purposes.

<u>Rates</u>

15% on registered value corrected according to the following factors:

- factor of 8 for property registered before December 31, 1970;
- factor of 4 for property registered between 1971 and 1980;
- factor of 2 for property registered between 1981 and 1990;
- factor of 1.5 for property registered between 1991 and April, 1993; and
- factor of 1 for property registered after May, 1993.

3- Taxes on property: Motor vehicle tax – See Law 13/93 for more details.

<u>Nature of Tax</u>

Levied on motor vehicles with engines larger than 50 c.c., registered in the country or 180 days from entry into the country.

<u>Exemptions</u>

- The government and its agencies, organizations, or services, except state-owned and mixed enterprises.
- Citizens of countries giving reciprocal treatment.
- Personnel of diplomatic and consular missions, and international or foreign organizations, pursuant to agreements.
- Farm tractors, driver-training vehicles, rental vehicles, registered boats used in artisan fishing and motorcycles for transporting freight.
- New vehicles purchased after October 31, 1997.

Rates

Taxes are renewed annually, and vary according to size and age of vehicle:

- 50–500 cc = 500 dobra if less than 6 years old, and 1,000 dobra if more;
- 501–1,300 cc = 2,500 dobra if less than 6 years old and 4,000 dobra if more;
- 1,301–1,900 cc = 4,000 dobra if less than 6 years old and 6,000 dobra if more;
- over 1,900 cc = 6,000 dobra if less than 6 years old;
- recreational boats up to 25 hp = 500 dobra if up to 6 years old, 1,000 dobra between 6-10 years; and 10,000 dobra if more than 10 years;
- over 25 hp, for each 10 hp or fraction = additional tariffs of 500 dobra for boats up to 6 years old and 1,000 dobra if more.

Source: São Tomé and Príncipe authorities.

APPENDIX III
SÃO TOMÉ AND PRÍNCIPE – SUMMARY OF TAX SYSTEM
INDIRECT TAX LAWS

Excise Tax – See Law 20/76; Law 14/93; Law 1/00; Law 35/00; Law 8/05; and Law 9/05 for more details and tax schedules.

Nature of Tax

The tax is payable by the producer and is levied on the provision of services and on the value of domestically produced goods. The tax is also payable by importers on the c.i.f. value of imports. The following valuation methods apply:

- The ex-factory price of domestically produced goods, unless distributed by an affiliated company or subsidiary;
- The sales price set by the distributor less 20 percent, when the producer is affiliated with it or with its subsidiary;
- The customs value of imported goods (c.i.f. plus customs duties).
- In case of direct sales to consumers by producers, the ex-factory price of the goods cannot be lower than the sale price less 20 percent.

Tax assessment must be submitted no later than the 10th day of each month The tax must be paid by the last business day of that month.

Exemptions

- Locally produced goods exported directly by the industrial establishment.
- Raw materials, equipment, and finished or semi-finished articles, imported or domestic, for processing or consumption by industries.
- Imported or domestic materials used for packaging agricultural goods for export.
- Alcohol, when needed in industrial processes and for medical or medical-related services.
- Goods imported by international organizations, foreign embassies and consulates, provided there is reciprocity of treatment.
- Crafts.
- Duty-free imported goods.
- Gasoline for vehicles of diplomats, subject to reciprocity, and of officials of international organizations, and gasoline for publicly used aviation equipment.

Rates

Petroleum products = 15% (Gasoline), 60% (Gas oil and diesel oil), 130% (petroleum).

Motor vehicles = 15–50% based on the value of the vehicle.

Alcoholic drinks = 25–130 % (e.g. domestic beer = 60%, imported beer = 120%, champagne = 100%, whisky = 120%, etc.)

Tobacco = 55 - 250%

All other imported goods = 2-20%

All domestically produced goods = 20%

Services = 5%

A detailed list of the products and tax rates are annexed to Law 20/76, modified by Law 14/93.

Taxes on international trade and transactions:

1- Import Duties – See Law 1/00; and Law 31/05 for more details.

Nature of Tax

Levied on the buyer on the value of imports, c.i.f.. The base price of imports also includes any royalties and trademark payments. Specific duties levied on the weight of goods are calculated on the basis of their gross, net, or actual weight.

Exemptions

- Goods imported by official agencies as specified in Decree 41024 of 1957 are exempt, including civil aviation aircrafts and engines; equipment, machinery, and accessories for use in any public service; fixed plant and rolling stock for railroads, hoists, and floating docks and cranes imported by the port and railroad agencies; electrical equipment for postal, telegraph, and telephone stations; construction materials, electrical equipment, and machinery and apparatus for use in water, and electricity distribution, or sewer systems, or by public works agencies; goods required for the country's development and the equipping of ports; and fertilizers and seeds for agricultural agencies.
- If private enterprises enjoy a tax incentive, they will still be subject to 5 percent import duty (Law 31/05 establishes that private enterprises cannot be exempted from import duties).

Rates

5% on basic goods – including all raw material or inputs for industry or agriculture;

20% on luxury goods; and

10% on all other goods – the majority of investment goods are taxed at 10%, although some are taxed at 20%.

In addition to the above rates, surtaxes apply to the following products:

Petroleum products, in addition to 5% import duty: Gasoline 144% surtax; Kerosene 4.4% surtax; Jet fuel 317% surtax; Diesel 57.9 % surtax.

Alcoholic beverages, in addition to 20% import duty: Beer 41% surtax; Wine 25% surtax; Spirits 55% surtax.

Cigarettes = 55% surtax, in addition to 20% import duty.

Vehicles = 0 to 20% surtax, depending on the age of the vehicle, in addition to 10 to 20% import duty.

2- Lighthouse User Fee – See Legislative Act 25 of 1933 for more details.

Nature of Tax

Levied on all ships entering domestic harbors and used to defray the costs of lighthouses, lighted beacons, and light buoys. The user fee is administered by the National Port Enterprise (ENAPORT) and is earmarked for harbor operations.

Exemptions

None.

Rates

150 to 650 dobra per ship, depending on the nationality of ship and the time of day.

3- Harbor Tax – See Decree-Law 22/89 for more details.

Nature of Tax

Levied for the use of port facilities, and on materiel procured from ENAPORT.

Exemptions

- Scientific missions, domestic ships, and fishing boats pay 50% of the tax.
- Government and military boats, merchandise in transit, merchandise shipped between domestic harbors, passenger luggage, and mail.
- Exemptions are also granted by ENAPORT on a case-by-case basis.

Rates

Most rates are in the form of specific tariffs that vary with the weight, volume, and quantity of merchandise, the type of service, and time of utilization of service.

For materiel procured from ENAPORT, a tax of 1% of the c.i.f. value applies, plus an additional tax of 30%.

Other taxes:

1- Inheritance and Gift Tax – See Decree 22 of 1988 and Law 42/93 for more details.

Nature of Tax

Levied on all inheritance/gifts of tangible property, real estate, value, or title. Payable by the recipient. The tax base is determined by the value of the inherited/gift goods or property, after deduction of deceased's debts and other costs.

Exemptions

- Inheritance/gifts of less than 5,000 dobra.
- The gratuitous inheritance/gifts of tangible or real estate to descendants or to nonprofit organizations.

Rates

7 to 25%, based on the value of the goods or property and the degree of kinship between the deceased and the heirs.

2- Real **estate transfer tax –** See Decree 22 of 1988 and Law 42/93 for more details.

Nature of Tax

Levied on all transfers of real estate and payable by the purchaser. The tax base is the value of the transfer or the assessed income from the property shown in the real estate register, whichever is higher. The tax base may also be determined through direct assessment. Taxable transactions include specifically:

- Sale or bartering of real estate, subject to the prior authorization of the Planning Minister under Article 1 of Law 48/75;
- Acquisitions of shares in companies other than business corporations that own real estate, if through such acquisitions one partner becomes the holder of at least 75% of the company's capital or the number of partners is reduced to a married couple;

- Purchases of land from freeholders and redemptions of property seized in tax enforcement proceedings.

Exemptions

- The State, nonprofit organizations, and recipients of real estate who are descendants, ascendants, husbands, wives, brothers or sisters, for property valued at less than 30,000 dobra.
- New buildings.

Rates

Rural and urban property = 10%.
Barter deeds = 5%.

3- Stamp Tax – See Law 12/76 and annexed schedule; Law 40/88; Law 15/93; Law 81/93; Law 12/96; and Law 7/05 for more details.

Nature of Tax

Levied in the form of revenue stamps, stamped forms, stamped bills, revenue stamps, collection advice stamps, customs stamps, check stamps, pharmaceutical stamps, and miscellaneous stamps. The stamp tax is levied upon assessment and payment, when it is due on acts and contracts subject to it, and when products subject to it are exhibited or sold.

Exemptions

- The state, religious institutions, and some items in the schedule annexed to the regulations.
- Transfers of foreign currency from abroad.

Rates

Examples:

- Stamped forms = 500 dobra.
- Revenue stamps = 1,500 dobra.
- Check stamps = 3 dobra for local payments and 15 dobra for payments abroad.

4- Service Stamp Tax – See Law 44/T/75; Law 11/86 for more details.

Nature of Tax

Tax on customs clearance and receipts, licenses, and certificates.

Exemptions

- The state, religious institutions, and some items in the schedule annexed to the regulations.
- Transfers of foreign currency from abroad.

Rates

For customs clearance and receipts - 2 to 10 dobra for values below 10,000 dobra;
- An ad valorem rate of 0.15% for values above 10,000 dobra.

For certificates - 100,000 dobra.

For licenses - for 25 identified activities - 100,000 to 500,000 dobra.

5- Special tax - Law 22/93.

Nature of Tax

Surtax on the total amount of the following taxes, fees, and other government revenues: import tax; rural property tax; justice, port, and customs duties; enforced collection proceeds; and tax violation proceeds.

Exemptions

None.

Rates

20%.

6- Military tax - Decree 17695 of 1929; Decree 29115 of 1938; Decree 32745 of 1943; Law 86/93.

Nature of Tax

Payable by all nationals exempt from military service.

Exemptions

- Disabled nationals;
- Students, until the end of their studies;
- Anyone who is part of military or paramilitary services, or who served in the army for at least five years.

Rates

750 dobra or 1,000 dobra depending on income level.

7- Justice tax - Law 18/87.

Nature of Tax

Due on the settlement value in legal cases.

Exemptions

None.

Rates

10 %.

Source: São Tomé and Príncipe authorities.

APPENDIX IV
EASE OF PAYING TAXES, 2009

The World Bank/IFC Doing Business includes a measure of the ease of paying taxes in 181 countries, which assesses three indicators: (i) the total tax rate (the cost of all taxes borne by the taxpayer); (ii) the time taken to comply with the major taxes; (iii) the number of tax payments for the major taxes.[34]

The idea behind the ease of paying taxes indicator is to give policymakers the ability to measure tax regulation performance in comparison to other countries, learn from global best practices, and prioritize reforms. The most popular reforms in 2007/2008 were reducing corporate income tax rates, and improving electronic filing and payments systems efficiency, and reducing the number of taxes paid by business.

The following tables compare São Tomé and Príncipe with Sub-Saharan African countries:

Ease of Paying Taxes, 2009 [1/]

Indicator	São Tomé and Principe	Sub-Saharan Africa
Payments (number)	42	37.8
Time (hours)	424	311.7
Profit tax (%)	35.5	21.5
Labor tax and contributions (%)	6.8	13.2
Other taxes (%)	4.9	32
Total tax rate (% profit)	47.2	66.7

Source: World Bank Doing Business Report 2009.

1/ The data shows the tax that a medium-size company must pay or withhold in a given year, as well as measures of the administrative burden in paying taxes (including the number of payments made; the number of hours spent preparing, filing, and paying; and the percentage of profits paid in taxes).

[34] See the World Bank (2009).

Ease of Paying taxes, 2009 Rankings [1/]				
Country	*Overall Ease of Paying Taxes*	Tax Payments	Time to Comply	Total Tax Rate
Mauritius	*11*	7	56	16
Botswana	*17*	57	43	10
South Africa	*23*	16	73	51
Ethiopia	*37*	62	71	34
Zambia	*38*	120	39	8
Seychelles	*40*	49	12	111
Swaziland	*52*	105	23	69
Lesotho	*54*	66	128	11
Comoros	*55*	62	20	124
Rwanda	*56*	111	54	44
Malawi	*58*	57	121	35
Liberia	*59*	99	53	62
Ghana	*65*	105	83	41
Uganda	*70*	99	81	54
Mozambique	*88*	120	89	52
Madagascar	*92*	82	93	94
Namibia	*96*	120	142	20
Gabon	*101*	84	113	101
Eritrea	*105*	56	79	171
Tanzania	*109*	148	60	102
Burundi	*114*	99	43	180
Cape Verde	*115*	164	20	139
Guinea Bissau	*117*	143	78	107
Nigeria	*120*	116	175	39
Niger	*120*	134	105	91
Angola	*130*	94	113	138
Chad	*130*	158	34	153
Burkina Faso	*132*	142	105	99
Togo	*147*	154	105	120
Cote d'Ivoire	*148*	172	105	104
Sao Tome and Principe	***151***	**134**	**152**	**114**
Congo, Dem. Rep.	*153*	99	124	178
Mali	*156*	165	105	135
Zimbabwe	*157*	153	98	156
Kenya	*158*	131	150	132
Sierra Leone	*160*	89	146	179
Equatorial Guinea	*161*	143	122	151
Benin	*165*	161	105	165
Guinea	*168*	162	149	126
Senegal	*170*	166	169	108
Cameroon	*171*	131	180	134
Gambia	*175*	149	144	181
Central African Republic	*178*	158	160	177
Congo, Rep.	*179*	169	166	161

Source: The World Bank Doing Business Report, 2009 - Paying Taxes 2009. PricewaterhouseCoopers.
1/ The low ranking on the ease of paying taxes indicates lower and less complex taxes with simple administrative processes for paying taxes and filing tax returns.