Mobilizing Revenue

Strengthening domestic revenue bases is key to creating fiscal space for Africa's developmental needs

Sanjeev Gupta and Shamsuddin Tareq

FINANCIAL flows to sub-Saharan Africa have increased sharply since 1980. Between 1980 and 2006, net aid (including debt relief) increased fivefold, remittances ninefold, and foreign direct investment fiftyfold. Increased resource flows into the region and the associated high growth rates have enabled these countries to scale up public spending, including on social sectors. As a result, education and health spending increased in the region's oil-importing countries, in relation to both GDP and total spending (see Chart 1).

While these increases in spending are welcome, they are insufficient to meet the vast needs of the region's population in a sustainable manner. It is therefore essential that donors live up to their commitments of increasing aid to these countries. But aid-receiving countries in the region could also do more to generate resources internally—and to ensure that both new and existing resources are used efficiently.

In this article, we propose expanding the tax base in these countries by capturing activities not adequately taxed because of policy or administrative weaknesses. Such a step—together with strengthened fiscal institutions—would hasten the progress of African countries toward achieving the Millennium Development Goals (MDGs) and produce an array of other benefits. This does not mean that tax rates should be increased. In fact, high tax rates in some countries in the region, particularly on mobile production factors (such as skilled labor and capital), may be hindering economic growth. An effective broadening of the revenue base may enable these countries to lower the tax rates while raising more revenue to finance pressing developmental needs.

The case for domestic resources

The average tax-to-GDP ratio in sub-Saharan Africa increased from less than 15 percent of GDP in 1980 to more than 18 percent in 2005. But virtually the entire increase in tax revenue in the region came from natural resource taxes, such as income from production sharing, royalties, and corporate income tax on oil and mining companies. Nonresource-related revenue increased by less than 1 percent of GDP over 25 years. Even in resource-rich countries, nonresource-related revenue has essentially been stagnant (Keen and Mansour, 2008).

Also, in many of Africa's low-income oil importers, domestic revenue mobilization has not kept pace with rising public spending. As a result, a growing share of current spending is financed by aid. For example, from 1997–99 to 2004–06, the share of current spending financed by aid increased from 16 percent to 36 percent in Ghana, from 22 percent to 40 percent in Tanzania, and from 60 percent to 70 percent in Uganda (see Chart 2).

It is not inappropriate for low-income countries to finance a rising share of their recurrent outlays from aid, one might argue. After all, these countries have pressing needs at this stage of their development, and increasing expenditures for infrastructure and human development would only promote growth over time. Although this argument has some merit, policymakers in these countries still need to take into account a number of other considerations.

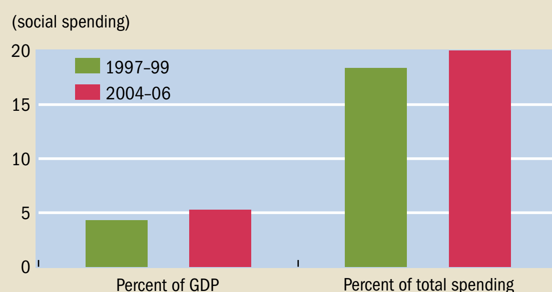
First, ***aid-financed projects give rise to additional spending, such as on operations and maintenance, which will need to be covered at least partly, if not wholly, from domestic resources.*** The country must generate sufficient revenue to finance these expenditures, or the productivity of aid-financed projects and assets will suffer.

Second, ***strengthened revenue mobilization contributes to economic stability, particularly in countries dependent on external financial flows.*** Rising domestic revenue not only creates additional fiscal space for supporting high-priority spending, it also allows a country to maintain spending con-

Chart 1

Higher social spending

With increased resource flows to Africa, governments have been able to ratchet up spending on education and health.



Source: IMF staff calculations.
Note: Data refer to simple averages of education and health spending at the central government level in 25 low-income oil importers.

Billboard in Accra, Ghana: A value-added tax has been introduced in virtually all countries in sub-Saharan Africa.

sistent with its policy priorities when aid is phased out. Ghana, Malawi, Rwanda, Tanzania, and Uganda all successfully created fiscal space through higher domestic revenue mobilization during 2000–06, demonstrating that it is feasible. Moreover, as low-income countries in sub-Saharan Africa develop into emerging market countries, they will need to strengthen their revenue collection accordingly (see Chart 3).

Increased domestic revenue can also help countries mitigate the adverse impact of volatility and uncertainty in aid flows, which can complicate budgetary management. Aid flows are more volatile than domestic revenue and significantly more so than remittances, and this volatility has increased over time. For example, Bulír and Hamann (2007) find that, even for countries that have benefited from the IMF's Heavily Indebted Poor Countries (HIPC) Initiative, the relative volatility of aid with respect to revenue (when variables are expressed as a share of GDP) has increased to 62 in 2000–03, compared with only 25 during 1997–98.

Third, ***expanding domestic revenue could also help Africa address the challenges arising from globalization.*** These countries are feeling the pressure to further liberalize their trading regimes, because their average tariff rate is higher than in other regions. Also, tariff rates in sub-Saharan Africa are expected to fall as a result of the formation of free trade areas and customs unions within the region as well as with other regional trading blocks, including the European Union. Currently, about a third of nonresource tax revenue in the region comes from trade taxes—about 4 percent of GDP—indicating that revenue loss from further trade liberalization would be significant. Strengthening the domestic revenue base could help recoup at least some losses from trade taxes.

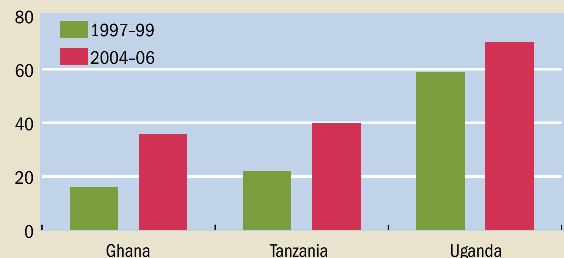
African countries are also confronted with increasing tax competition on corporate income tax (CIT), as countries compete more aggressively to attract foreign invest-

Chart 2

Worrisome trend

In many countries, a growing share of current spending is now financed by aid.

(share of current spending financed by aid, percent)



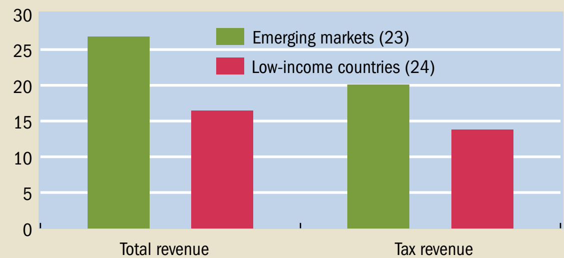
Source: IMF staff calculations.

Chart 3

Time to catch up

Tax collection levels of emerging market countries are significantly higher than those of low-income countries.

(revenue, percent of GDP)



Source: IMF staff calculations.
Note: Simple averages for the period 2004–06, with sample sizes in parentheses. Tax revenue for low-income countries refers to the 2004–05 average.

ment. Although statutory CIT rates in the region fell markedly in the 1990s, CIT revenue as a share of GDP has remained broadly unchanged, suggesting that the impact of rate reductions on revenue has been mitigated by other factors (Keen and Mansour, 2008). Nevertheless, the trend worldwide is toward lower statutory CIT rates, and rates in sub-Saharan African countries are still relatively high. This implies that these countries remain under pressure to further reduce CIT rates, which in turn means that the tax base should be broadened in order to minimize the impact on tax revenue.

Fourth, ***greater reliance on domestic revenues reduces the risk of Dutch disease***, which occurs when the exchange rate appreciates as a result of capital inflows, making the country's exports less competitive. A key challenge in managing scaled-up external inflows is the potential impact on the real exchange rate, exports, and competitiveness (Gupta, Powell, and Yang, 2006). Increasing domestic revenue means that there is less risk of being affected by Dutch disease.

Fifth, ***taxation increases incentives for public participation in the political process and creates pressure for more accountability, better governance, and improved efficiency of government spending.*** It fosters awareness to limit rent seeking (that is, lobbying for tax breaks or protection from foreign competition) in public policy by interest groups. Taxation also creates incentives for governments to upgrade their institutions for tax collection and administration and to provide more public services (Moore, 2007).

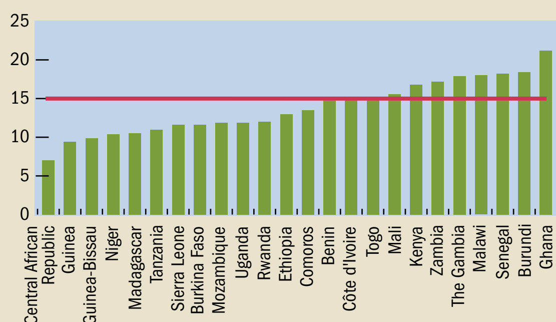
Sixth, ***domestic revenue mobilization can help strengthen fiscal institutions***. Stable and predictable revenue facilitates medium-term fiscal planning, which can help ensure that resources are allocated to priority sectors and that these allocations are effectively translated into outcomes. In fact, the efficiency of social spending has a strong positive correlation with the quality of fiscal institutions (Gupta et al., 2008).

Chart 4

Raising the bar

Many oil-importing countries in Africa have a strikingly low tax-to-GDP ratio, but a target of at least 15 percent is desirable.

(tax revenue, percent of GDP)



Source: IMF staff calculations.
Note: Data refer to simple averages in each country for 2004–05.

Revenue-raising potential

What is the potential for strengthening domestic revenue bases in sub-Saharan African countries? The revenue performance across oil exporters in the region varies; many countries have relatively high revenue-to-GDP ratios. These countries need to improve the efficiency of their tax systems to promote investment in nonresource sectors, which would help diversify their tax base. Countries that have low revenue-to-GDP ratios should strive to boost domestic tax revenue over the medium term.

In low-income African countries, domestic revenue remains low, at about 16.5 percent of GDP. Tax revenue is about 14 percent of GDP on average. A tax-to-GDP ratio of at least 15 percent is considered a reasonable target for most low-income countries (Keen and Simone, 2004). Many low-income African countries that are not rich in resources have a tax-to-GDP ratio well below 15 percent of GDP (see Chart 4).

Several studies indicate that developing countries have the potential for greater domestic revenue mobilization. The United Nations Millennium Project (2005) estimated that these countries could increase their domestic revenue by about 4 percent of GDP over the next 10 years. Similarly, the Commission on Macroeconomics and Health (World Health Organization, 2002) concluded that most countries could raise an additional 1–2 percent of GDP for financing additional health spending.

What it will take

Direct taxation, in the form of corporate or personal income tax, exists in all countries, but its potential has not yet been fully exploited. There are many large taxpayers who are benefiting from rising commodity prices, but they are not paying taxes commensurate with their income. Fine-tuning the policy and the administration governing the taxation of these taxpayers' incomes would help a number of countries raise additional revenue. However, the high share of agriculture and the informal sector in the economies of many countries is an important constraint in raising more revenue from direct taxation.

A value-added tax (VAT) has been introduced in virtually all countries in sub-Saharan Africa. To maximize revenue from VAT, countries need to ensure that the tax base is as broad as possible and the rate structure simple. Excise taxes are levied on products such as alcohol, tobacco, petroleum products, vehicles, and spare parts, but their yield in some countries has eroded because of rising prices. During 2007–08, many African countries reduced taxes (both import duties and consumption taxes) on fuel and food in response to higher international prices of these commodities. This has helped mitigate the impact of rising prices, particularly on the poor. But eventually, these countries would need to recoup some of the resulting revenue losses through rationalization of domestic taxation.

Rationalizing tax incentives can also generate substantial revenue (without negating the role of such incentives in improving the investment climate). Tax incentives in sub-Saharan Africa are now used more widely than in the 1980s, with more than two-thirds of the countries in the region providing tax holidays to attract investment. The number of countries using free zones that offer tax holidays has also dramatically increased. Moreover, low-income countries

in the region use such incentives more extensively than do middle-income countries—yet foreign direct investment in sub-Saharan Africa, other than in the resource sector, has increased very little over the past two decades.

Such incentives not only shrink the tax base but also complicate tax administration and are a major source of revenue loss and leakage from the taxed economy. Because investment decisions depend on a host of factors that often carry more weight than tax incentives, these countries need to improve the business climate while keeping the tax considerations as neutral as possible for investors.

Countries should also take steps to strengthen tax administration, because weak administrative capacity and poor governance are important constraints to raising revenue in many countries. Policies should focus on strengthening the technical capacity and organization of revenue authorities through computerization and improved operating procedures. Stricter enforcement mechanisms as well as improved tax audits and inspections could also contribute to increased taxpayer compliance. Tanzania and Uganda, for instance, have succeeded in improving domestic revenue performance by strengthening tax administration.

Effective resource use

Achieving the MDGs will require not only higher spending but also more efficient spending. Improving budget systems of African countries is therefore critical. Weaknesses in these systems can undermine budgetary planning, execution, and reporting, and result in the squandering of scarce public resources. Expenditure-tracking surveys have pointed to substantial leakage of public funds in some countries—revealing, for example, that during 1991–95, less than 15 percent of the nonwage budgetary allocation for education in the central government budget actually reached the schools in Uganda. Similarly, other surveys point to leakage of about 60 percent in education spending in Zambia in 2002 and in Tanzania in 1999. In response, countries are taking strong action to address these weaknesses. By 2001, leakage of education funds in Uganda was reduced to only 18 percent. Nevertheless, public financial management systems remain weak in many low-income countries.

Countries can take a number of steps to strengthen their public financial management systems, such as ***putting in place an adequate and coherent accounting framework*** for tracking spending, enforcing accountability, and meeting fiduciary requirements; ***regular and timely fiscal reporting; and establishing a sound system of internal control*** to ensure that public expenditure is executed in accordance with the approved budget and the established regulatory framework.

Many countries also urgently need to ***develop effective audit procedures***. In addition, budget planning in many countries lacks a medium-term focus; only a few countries in sub-Saharan Africa have fully developed medium-term frameworks. And even in countries where such frameworks exist, they are often not well integrated with the budget or used for analytical purposes. These problems reflect both the complexity of developing these frameworks and the lack of adequate capacity, particularly in the line ministries. Countries should strive to ***develop medium-term frameworks in a phased manner consistent with improvements in local capacity***.

Maximizing the benefits

Domestic revenue levels in most sub-Saharan African countries remain low by international standards. Countries should intensify efforts to raise the tax-to-GDP ratios to at least 15 percent. Given the current levels of tax rates and increasing tax competition, however, further increases in tax rates—particularly on mobile production factors—are neither feasible nor desirable. Instead, broadening the tax base—including through bringing the informal sector into the tax net—is a more effective way of generating domestic revenue and has the advantage of improving the perceived equity of the tax system, which is a key consideration in many countries. These reforms should be complemented by measures to strengthen revenue administration.

Resources must also be managed efficiently so that the people of sub-Saharan Africa receive the maximum benefit. To this end, these countries must further strengthen institutions, in particular public financial management systems, which will cut down on waste and reduce the incidence of fund misappropriation by promoting transparency and enhancing governance. Countries should also develop appropriately sequenced reform plans for strengthening these systems, taking into account the local capacity to undertake the reforms. ■

Sanjeev Gupta is a Senior Advisor in the IMF's Fiscal Affairs Department, in which Shamsuddin Tareq is a Deputy Division Chief.

References:

Bulír, Alěs, and A. Javier Hamann, 2007, "Volatility of Development Aid: An Update," IMF Staff Papers, *Vol. 54, No. 4, pp. 727–34.*

Gupta, Sanjeev, Robert Powell, and Yongzheng Yang, 2006, Macroeconomic Challenges of Scaling Up Aid to Africa: A Checklist for Practitioners *(Washington: International Monetary Fund).*

Gupta, Sanjeev, Gerd Schwartz, Shamsuddin Tareq, Richard Allen, Isabell Adenauer, Kevin Fletcher, and Duncan Last, 2008, Fiscal Management of Scaled-Up Aid *(Washington: International Monetary Fund).*

Keen, Michael, and Mario Mansour, 2008, "Revenue Mobilization in Sub-Saharan Africa: Key Challenges from Globalization," paper presented at the conference, "Globalization and Revenue Mobilization," Abuja, Nigeria, February.

Keen, Michael, and Alejandro Simone, 2004, "Tax Policy in Developing Countries: Some Lessons for the 1990s and Some Challenges Ahead," in Helping Countries Develop: The Role of Fiscal Policy, *ed. by Sanjeev Gupta, Gabriela Inchauste, and Benedict Clements (Washington: International Monetary Fund).*

Moore, Mick, 2007, "How Does Taxation Affect the Quality of Governance?" Institute of Development Studies Working Paper 280 (Brighton, United Kingdom: Institute of Development Studies).

United Nations Millennium Project, 2005, Investing in Development: A Practical Plan to Achieve the Millennium Development Goals *(New York: United Nations).*

World Health Organization, 2002, Mobilization of Domestic Resources For Health, *Report of Working Group 3 of the Commission on Macroeconomics and Health (Geneva: World Health Organization).*