# TAXATION AND AID FOR DOMESTIC RESOURCE MOBILIZATION (D.R.M.) AID: HELPING OR HARMING DOMESTIC RESOURCE MOBILIZATION IN AFRICA

My presentation deals with

i. **Definition and Importance of Domestic Resource Mobilization to African countries**

ii. **The need for Foreign Aid to fund budgetary gaps in recurrent expenditure**

iii. **Issues associated with Foreign Aid**

iv. **Challenges associated with D.R.M.**

v. **Opportunities for enhancing D.R.M.**

vi. **Conclusion**

## A. INTRODUCTION

Domestic Resource Mobilization (D.R.M.) refers to the generation of savings from domestic resources and their allocation to economically and socially productive investments. Such resource allocation can come from both the public and private sectors. The public sector does this through taxation and other forms of public revenue generation.

D.R.M. is important to African countries because

- it is potentially the biggest source of long term financing for sustainable development and it is the life blood of all state governance such as the provision of public goods and services.
- it can help strengthen fiscal institutions because stable and predictable revenue facilitates long term fiscal planning which can help ensure that resources are allocated to priority sectors and are translated into outcomes.
- coupled with economic growth is the antidote to long term aid dependency and increased ownership and policy space to implement strategies that reflect development priorities. It also ensures accountable government in provision of the terms of social contracts with the governed.

Most African countries have shown encouraging trends in D.R.M. growth in recent years. Enormous challenges however still remain. In sub-Saharan Africa D.R.M. constitutes about 70% of development finance which means there is a deficit of 30% usually filled by loans or Aid or other forms of public finance.

## B. THE NEED FOR FOREIGN AID

It is in a bid to finance the remaining 30% that African countries have a need for aid. In low income oil importing countries such as Ghana D.R.M. has not kept pace with rising public expenditure. It therefore stands to reason that most African countries would necessarily need aid to supplement their recurrent expenditure.

The question then is, is foreign aid the remedy or African countries can be strengthened to increase their D.R.M? In my opinion African countries should increase their capacity to mobilize D.R.M. and be weaned off foreign aid. But what are the realities?

### Issues associated with foreign aid

- Reliance on foreign aid flows can be very volatile and has the potential of aggravating the microeconomic development in developing countries eg. of Rwanda. It is normally geared towards solutions of short term problems rather than long term developmental considerations.
- Foreign Aid has the capacity to make most African countries oblivious of their potential wealth eg. electricity in Africa.
- Foreign aid can inadvertently undermine the foundation of a tax based bargain between the state and its citizens and this underlines the need for donors to focus on the drivers of improved governance within the longer perspective of progressively fading out aid.
- Only a small fraction of 2% of bilateral aid for government administration, economic policy and public financial management was focused on tax related assistance in 2008. The 2002 Monterrey Consensus in Financing for Development (UNO, 2002) intimated that between developed and Aid dependent economies aid is provided in the short term whilst partner countries commit to enhancing resource mobilization in the long term.

## C. CHALLENGES ASSOCIATED WITH DOMESTIC REVENUE MOBILIZATION

### a. Low Savings

- The main problem with mobilization of resource in Africa are that not enough savings are generated to facilitate the required investments. In African countries savings rates are low and do not compare with that of Asia. The gross domestic saving in sub-Saharan Africa amounted to17.6% of GDP in 2006 compared to 26% in South Asia and about 43% in East Asia and Pacific countries (World Bank, 2007). The low saving rate in sub Saharan Africa explains the low level of economic activity in the region and the slow pace of growth. Other factors include the very low levels of financial intermediation and credit on the continent and the fact that over 40% of African savings are invested outside Africa.

**b. Capital flight**

Capital flight remains the single most impactful stumbling blocks to D.R.M. Tax flights from developing countries are estimated to be several times higher than aggregate inflows from development assistance. Capital flight severely weakens D.R.M. in Africa. It undermines social contracts and damages good governance. In the context of Africa the United Nations Conference on Trade and Development (UNCTAD) estimated in 2007 that capital flight caused considerable damage because African investments world- wide were worth 400billion US dollars which was double the entire African debt worth 215billionUS dollars.

**c. Tax Incentives and Exemptions**

This paper adopts the definition in Fleischer, (2002) who defines tax incentives as "any tax provision granted to a qualified investment project that represents a favorable deviation from the provisions applicable to investment projects in general." The economic theory is that it acts as a tool for promoting investments. In practice however, it has been observed that tax incentives distort resource allocation leading to some sub-optimal investment decisions and therefore harmful to long term growth.

- Tax incentives are not the primary determinants of the decision to invest. instead most investors base their investment decisions on economic and commercial factors on one hand and institutional and regulatory factors on the other.
- Often many multinationals enjoy foreign tax credit at home and giving them tax incentives may have minimal impact on their profit which in effect allows the developed home country to be the final beneficiary of the tax break.
- Finally most often, start- up companies make losses for several years and do not benefit from tax exemptions. It is however the firms that make profit from the start that benefit

from tax exemptions and these would have invested anyway. Typical example is the housing industry in Ghana.

- In Kenya there are 11 export promotion and investment related incentives targeted at enhancing investment and export growth and employment creation, although these have led to revenue losses

**Table 1**

**KRA estimated revenue loss over2003/04-2007/08 from tax incentives (Kshs.Million)**

| Tax Incentives | 2003 / 04 | 2004 / 05 | 2005 / 06 | 2006 / 07 |
|---|---|---|---|---|
| GROUND SUMMARY | 17,154 | 22,338 | 31,671 | 51,747 |
| GROSS DOMESTIC PRODUCT | 1,202,878 | 1,346,023 | 1,519,402 | 1,717,488 |
| REVENUE FORGONE AS % OF GDP | 1.43% | 1.66% | 2.08% | 1.85% |

From the UNCTAD world investment report in the year 2006, FDI stock as a percentage of gross domestic product in Kenya was 5.0%.Tanzania was 47.6% whilst East African countries averaged 20.8%. This gives credence to the fact that incentives and exemptions are inadequate to attract high levels of investment. Rather they lead to revenue loss.

### d. “Paradox of plenty”

Africa is faced with what is referred to as the “paradox of plenty”. A characteristic of many mineral rich countries in Africa is that countries with the rich natural resources are often the worst governed. The average tax to GDP ratio in such countries in Sub Saharan Africa increased from less than 15% of GDP in 1980 to 18% in 2005. However virtually the entire increase in tax revenue in these countries came from natural resource taxes such as income from production sharing, royalties and corporate income tax from oil and mining companies.

### e. ‘Pareto’ Principle

There are only a few tax payers who contribute a bulk of the taxes. In Ghana 20% of tax payers contribute 80% of direct tax revenue and the remaining 80% contribute only 20%.This is because we are faced with the reality of a large share in agriculture and employment in total output. The main characteristics are; large informal sectors and occupations, and many small establishments;

Small share of wages in total national income, a small share of total consumer spending made in large informal economies that are outside the tax structures. The tax base that is potentially reachable constitutes a smaller portion of total economic activity than in developed countries.

**f. Weak Administrative systems and organizational capacities**

There are weak administrative systems, scarce and poor quality data as a result of widespread informal activities. Limited reporting and low levels of education in the general population and seemingly a general culture of non compliance which accounts for the low D.R.M. There is a challenge of organizational capacity and resourcing where staff of most tax administrations in Africa lack the requisite capacity to perform efficiently. Resources to pay good wages is not available as in the private sector. Communication capacity is limited and the resource to purchase machinery and equipment necessary to facilitate work is also not available. Where mail service is not available or limited it is difficult to create an efficient tax administration. Automation of business processes is virtually limited to few scattered areas.

g. **Other challenges** include high taxes which encourages tax evasion and otehr loopholes that undermine collection. Complex tax legislation, difficult to understand even by the educated tax payer and discretion on the part of tax officials which leads to corruption. There is also lack of political will to insulate tax administration from political incursions.

## D. OPPORTUNITIES FOR ENHANCING DOMESTIC RESOURCE MOBILIZATION

There is no single set of solutions that would ensure improved D.R.M. in Africa. This is because countries exhibit wide variety of tax compliance levels which reflects not only the effectiveness of their tax administration but also taxpayer attitude towards taxation and governance in general. The suggested solutions enumerated below would obviously not be exhaustive but would be among those that can help African countries enhance their D.R.M.

i. **At the Country Level**

a. <u>Inter-African Trade</u>

Africa can only experience meaningful development through co-operation and trade in goods and services within its borders as well as the outside world. It is well documented that prior to introduction of borders by the colonialists, Africans were trading with their neighbours. Trade co-operation will obviously bring down trade barriers which would eventually erode custom duties which is the main source of domestic revenue for most African countries. It will therefore be important to strengthen internal trade when trade barriers are finally eliminated

b. <u>Broadening the existing tax base</u>

Most African countries are beset with very large informal sectors and underground economies where cash transactions do not leave any audit trails for tax purposes. It will therefore be necessary to find ways of taxing the informal sector. In Ghana it is estimated that the informal sector provides employment to between 60 to 70% of people employed in the country. Many of these employees did not pay PAYE taxes. Even where the income is declared it is grossly underestimated and it is always difficult to challenge such claims by employers in the informal sector. In Ghana payment of tax from the informal sector constitute an average of 5% of direct tax revenue as indicated in the table below.

Percentage of Self Employed to Total Revenue Collection

| Year | Self Employed GH¢ | Total Collection GH¢ | % of Self Employed |
|---|---|---|---|
| 2006 | 35,944,800.50 | 734,135,447.80 | 4.90 |
| 2007 | 45,589,162.24 | 910,235,784.12 | 5.01 |
| 2008 | 64,084,359.29 | 1,234,067,097.97 | 5.19 |

c. <u>Improvement in Tax Administration Capacity</u>

There is the need to automate the business processes and procedures of tax administration in Africa. This would eliminate the element of discretion on the part of tax officials and reduce corruption. African Tax Administrations should be restructured to address the issue of a large informal sector in our economies. Tax officials should be trained in current methods of auditing to be able to audit multinational companies. African governments should provide adequate resources in terms of salaries and wages, equipment and machinery and a congenial work environment within which tax officials work.

d. Rationalization of Tax Incentives

In the light of globalization new considerations have come into play. These include

- favourable foreign direct investment climate including transparent and non discriminatory environment effective compliance policies, efficient judiciary as well as low and stable tax rate.
- low transaction and business cost, dealing primarily with investment labour and trading regulations, ease of exit and entry, environmental regulation, tax and legal systems.

- Suppliers network ie. Country's dynamic local firm can attract direct foreign investments that sub-contract services and components with the production services with the local firms

- Human capital – there is an increasing demand for human capital with diversified modern skills that can cope with the modern technologies and for flexible labour market
- Low cost infrastructure especially in the transportation and communication sectors.

The factors above make it clear that tax incentives perse have a limited role in determining the country's attractiveness as an investment destination.

e. Strengthen Tax Policy

Tax policy designs must take the administrative dimension of taxation carefully into account. Tax policies initiated should take into consideration whether such policies are applicable elsewhere. There should be transparency and accountability in these policies, and should lend themselves to public and civil society scrutiny. Tax policies should ensure the predictability and equity of taxes in order that it does not lead to opportunistic tax avoidance and possibly evasion.

ii. **Regional Level**

a. We have to deepen the international consensus and debate on the importance of the Domestic Resource Mobilization in Africa.
b. Take more effective international tax action to tackle tax fraud and evasion across borders
c. Strengthen tax harmonization and regional integration
d. Provide institutional support to African countries to strengthen revenue governance and reform tax system and improve efficiency of tax administrations.

## CONCLUSION

I wish to conclude that African countries can be weaned off aid and are capable of mobilizing revenue domestically to finance public expenditure if we are assisted to do so and the formation of the African Tax Administration Forum (ATAF) is in the right direction towards achieving that objective.