Africa's Lost Tax Revenue, Lost Development Opportunities

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Tax policy plays a major role in shaping development outcomes. While tax is not an end in itself, the role played by a suitably designed mix of tax policies in securing sustainable public finances, promoting equitable growth, dampening harmful social and ecological outcomes, and building democratic states, is well established (Kaldor 1980; Brautigam, Feldstad, and Moore 2008). However, the research that has been conducted on how tax policies shapes development outcomes often lacks sufficient detail on specific country cases (Bird 2010). Almost invariably, tax revenue provides the cheapest means of funding public investments in education, health, physical infrastructure, crime prevention, and public defense. Tax is also core to the social contract between citizens and state: citizens as taxpayers want assurance that everyone pays their fair share and that the revenue collected is being spent wisely on their behalf. Citizens are far more likely to pay taxes when they feel that politicians are honoring the social contract and that tax policies are legitimate and applied fairly.

Tax injustices are rife in many African countries, as they are in many (most!) countries around the world (http://www.taxjustice.net/cms/upload/pdf/tuiyc_africa_final.pdf). Tax evasion and tax avoidance are widespread among wealthy and corporate elites. In addition, a large proportion of the micro-businesses that predominate in the majority of African countries operate outside the formal economies, reducing labor productivity and slowing growth. With this enormous scale of evasion and avoidance, tax departments fall far short of having sufficient staff and resourcing to tackle these endemic problems. Much African-origin wealth has been accumulated in secret offshore companies, trusts, and bank accounts (Henry 2012). But international efforts to curtail tax havens have been weak and largely ineffective. Unnecessary and typically harmful tax exemptions proliferate, not least for the ruling elites themselves. Tax regimes have become increasingly regressive in their impacts on poorer people, with indirect taxes being substituted for more progressive income, wealth, and property taxes. In many natural-resource-exporting countries, rulers have found it easier and more personally rewarding to make special tax deals with multinational companies than to go through the more arduous and time-consuming process of being accountable to their citizens.

The long-term outcomes in many countries have included low tax yields, requiring excessive reliance on external debt or foreign aid; under-investment in public goods such as health, education, training, and research; and widespread public disenchantment with the legitimacy of taxes and the state itself. These weaknesses have impacted the potential for sustainable growth and social and political stability, fueling a vicious circle of underdevelopment. This encourages the most harmful of all types of capital flight: the long-term exodus of Africa's brightest and most innovative people, whose departure leaves the continent bereft of the skills and flair required for sustainable development.

If poorer countries are to escape from aid dependency and the grip of external debt, and from poverty more broadly, it is essential that their revenue authorities have the capacity to collect taxes efficiently and in ways that are just and equitable. This requires measures both to enhance internal tax collection and also to reduce the barriers created by tax havens and international accounting and tax rules that are quite simply not fit for their intended purposes. Clearly the time has come to put tax justice on the agenda.

Recent trends, and what they hide

At first glance tax revenue trends since 1990 in many African countries appear positive. Collected taxes have increased from 22 per cent of GDP in 1990 to 27 percent in 2007 (OECD 2010, 84). But these figures mask important factors that shape development prospects. Revenues from oil and mineral exports account for the majority of this increase. Revenue from other trade taxes has declined. Revenue from indirect taxes has likewise declined and the widespread adoption of Value Added Tax has generally had a regressive impact on poorer households. The overall trend in collection of direct taxes on personal incomes and corporate profits has been flat (OECD 2010, 90).

The big picture is therefore one which shows that mineral exporting countries such as Algeria, Angola, Chad, Gabon, and Libya have been successful in capturing economic rents during commodity boom times, while non-mineral exporters, particularly very low income countries such as Ethiopia, Guinea-Bissau, Mali, and Sudan, have been less successful in the arduous task of raising revenue from personal and corporate income taxes, and from taxes on wealth and property.

It is especially notable that yields from corporate income taxes have not increased in line with economic growth trends in recent years. Several factors might explain this. First, statutory tax rates have been reduced in many African countries, in parallel with a global race to the bottom in taxes on corporate incomes. Second, the past 30 years have seen a remarkable increase in the granting of corporate tax exemptions in a variety of different forms, including tax holidays, special rates, accelerated depreciation rates, and others. While there is no evidence that these exemptions are essential to attracting inbound investment that contributes to long-term growth, there can be little doubt that they provide incentives to domestic investors to accumulate their capital in secret offshore structures, subsequently round tripping that capital to the country of origin dressed up as foreign direct investment. OECD and IMF officials have privately conceded to the author that this round tripping probably occurs on a significant scale, but they are unable to quantify that scale due to offshore secrecy. A third explanatory factor behind the flat-lining corporate tax yields is the increased sophistication of corporate tax avoidance, which is globally systemic.

Tax avoidance, particularly involving transfer pricing, undermines markets by distorting competition in favor of multinational companies (MNCs), which can and do use transfer pricing extensively to shift their profits to tax havens. This works to the disadvantage of the small and medium enterprises (SMEs) that typically provide the engines of innovation and job creation in most economies. This distorted playing field between MNCs and SMEs reduces price competition, lowers corporate tax yields, harms innovation, and favors capital-intensive over labor-intensive production technologies. These negative impacts are cumulatively harmful to development prospects, particularly for countries with high levels of under-employment.

Equally disturbing is the weak revenue growth from personal income taxes. Commodity booms and privatizations of monopoly sectors such as telecoms have contributed to the accumulation of extraordinary levels of personal wealth among African elites, who generally prefer to hold a large proportion of their wealth offshore. Several factors, not least personal security, shape this decision to hold wealth offshore. But the invariable outcome of illicit financial outflows to secrecy jurisdictions is that development prospects are undermined both by loss of investment capital and by endemic tax evasion (Christensen 2009a). Although hard to quantify, the real impacts on development are stark.

One estimate suggests that repatriation of just one quarter of the accumulated stock of illicit financial outflows from Africa would lead to a near doubling of the ratio of domestic investment to GDP (Fofack and Ndikumana 2010).

This in turn impacts the quality of governance in Africa. The majority of African people engaged in illicit financial flows to offshore secrecy jurisdictions come from the elite 1 percent. In many cases they have accumulated their wealth through corrupt activities, often embezzling public or private assets, which they subsequently transfer offshore. This elite has little or no interest in investing in their own domestic economies. They are protected from the social impacts of inequality and disorder by having overseas residences and access for themselves and their families to elite schools and hospitals in other countries. In short, they have every incentive to retain the status quo which enables looting and protects their ill-gotten gains, and to block progressive measures that might strengthen international cooperation and domestic governance. They are aided in this project by the global infrastructure of banks, accounting and legal firms, and secrecy jurisdictions which provide the supply-side infrastructure that enables and encourages their corrupt activities.[1]

Barriers to progressive tax regimes in Africa

African tax policy makers face formidable barriers in the way of creating progressive, pro-poor tax regimes. Some barriers arise from domestic factors such as the scale of informal sectors, the power of political and wealthy elites to secure tax exemptions and special tax treatments while also resisting and evading progressive taxes on wealth and property, and the under-resourcing of national and regional tax departments. Domestic structural barriers are compounded by external factors such as the protracted failure of the relevant international organizations to tackle transfer pricing abuses by multinational companies (Christensen 2009b) and the global scandal of tax havens and secrecy jurisdictions (Shaxson 2011, available at http://treasureislands.org/the-book/).

At the domestic level, seeking to bring the informal sector into the taxed formal sector offers opportunities not just for increased tax revenues, but also for higher levels of productivity, faster growth rates, and enhanced social inclusion. If, however, the costs of entering the sector are too high for small firms, and particularly for the micro-businesses that currently dominate most African informal economies, then most are likely to choose to remain outside the system (Jütting and de Laiglesia 2009). Addressing this issue requires changes in several factors, including the administrative capacity of the tax authorities, a cultural shift of attitudes to the legitimacy of state tax raising powers, and a tax mix that does not impose too much complexity or bureaucracy on small traders and micro-businesses.

African countries are hardly unique in suffering a proliferation of tax exemptions and preferential tax treatments, often targeting specific groups who normally fall into the elite category. These exemptions and special treatments seldom serve useful purposes and typically have negative outcomes, including the corrupting process of endless behind-the-scenes lobbying for yet more exemptions. While it is hard to quantify revenue losses from such exemptions, and recognizing that some exemptions may have an overall progressive impact on poorer households, one recent estimate suggests that four East African countries, Kenya, Rwanda, Tanzania and Uganda, are losing up to US$2.8 billion annually from tax incentives and exemptions. Much of this loss is due to incentives and exemptions aimed at attracting foreign direct investment (Tax Justice Network Africa and Action

[1] http://www.realinstitutoelcano.org/wps/portal/rielcano_eng/Content?WCM_GLOBAL_CONTEXT=/elcano/elcano_in/zonas_in/sub-saharan+africa/dt1-2009.

Aid 2012).[2] Proposals for new tax incentives and exemptions should therefore be treated with great caution, even when the intention is to create an incentive to invest. Other factors such as the availability of a trained workforce, or raw material inputs, or transport infrastructure, are typically far more important to investors. Tax incentives carry expenditure costs, which should be carefully evaluated since they involve revenues effectively foregone. They also risk undermining the integrity of the tax system, with knock-on effects on tax legitimacy and market efficiency.

Several case studies have been published in recent years of transfer pricing involving African countries (Christian Aid 2009; Action Aid 2012). But it is important to keep in mind that this problem is systemic rather than a case of a few rotten apples in the corporate barrel. The problems stem from the inherent weaknesses of the guidelines established by the Organisation for Economic Cooperation and Development (OECD) under the rubric of its arm's length method for pricing internal transactions within multinational companies. The practical problems associated with trying to apply the arm's length method are well known to African tax authorities.[3] But the intellectual weaknesses of the arm's length method also pose insurmountable challenges, especially in relation to transfer pricing abuses involving provision of management and similar intangible services and to the pricing of intellectual property rights (Sheppard 2012). Practical alternatives do exist, however, that do not involve applying the arm's length method. Many developing countries are experimenting with such alternative ways of tackling transfer pricing abuse (Valadão 2012; Zhang 2012).

The specter of tax havens has loomed large on the global political agenda in recent years. Tax havens are recognized to have played important roles in weakening financial market regulation and enabling illicit cross-border financial flows. Some commentators portray tax havens as supply-side agents in providing an enabling environment for corrupt activities: according to their argument the supply of secrecy services from tax havens creates a 'criminogenic' market environment, in which banks, accounting and legal firms, and others are willing to provide support services for illicit financial flows because these services generate highly profitable fee rates (Shaxson 2011; Christensen 2012). In 2009, two years after financial crises hit European and North American markets, the G20 countries agreed in London to tackle tax havens and abolish the banking secrecy that encourages and enables companies and super-rich people—the high net-worth clients so sought after by the offshore wealth management industry—to evade taxes in their normal country of residence. This G20 initiative has had limited success, however. This is due to its reliance on weak OECD standards for tax information exchange between tax havens and other countries, and partly due to the lack of pressure from developing countries, including African countries, to use this opportunity to tackle offshore secrecy. As the British Parliament's International Development Committee notes in its 2012 report on tax and development:

> "The capacity of a developing country tax authority to obtain information on the offshore activities of its citizens or corporations (i.e. information from foreign tax authorities) is critical to its ability to curtail illicit capital flight." (IDC 2012, 23)

While African countries are not members of the OECD, the African Tax Administrator's Forum is well placed to put pressure on the OECD to strengthen its information exchange standards by adopting automatic exchange as the effective global standard and extending it multilaterally rather than through bilateral treaty processes. More importantly, however, African countries as members of the United Nations, are under-represented on the UN's Committee of Experts on International Cooperation on Tax Matters, and few

[2] http://www.actionaid.org/sites/files/actionaid/eac_report.pdf

[3] http://www.taxjustice.net/cms/upload/pdf/Gerdi_van_der_Westhuysen_1206_Helsinki_ppt.pdf

African countries send representatives to observe that Committee. African countries can use their collective political weight to push UN ECOSOC to strengthen the Committee by granting it inter-governmental status, and push the Committee to create a multilateral system which uses automatic information exchange as the effective global standard.[4] Significantly, in 2012 the OECD acknowledged that automatic information exchange is effective as a deterrent to illicit financial flows and tax evasion, so the pathway is clear for African countries to require its implementation by offshore secrecy jurisdictions.

Catching up on lost opportunities

Increasing tax yields represents a challenge for African tax authorities. But this is a crucial part of mobilizing Africa's domestic resources for development. While aid remains a short- term necessity for some poorer countries, the long-term goal must be to increase the domestic savings rate to reduce dependence on external investment sources. With such a large proportion of Africa's private savings currently being hidden away in secret offshore trusts and bank accounts, the scope for raising revenues in an equitable, pro-poor way is limited. Tackling illicit financial outflows must therefore be seen as a high priority.

Much can be done both to curtail current outflows and encourage repatriation of savings shifted offshore years ago. The most effective way of achieving this lies with strengthening international cooperation on information exchange to deter citizens from holding savings offshore to evade taxes. Once the secrecy incentives to use offshore structures to hold assets offshore and evade taxes are removed, the supply-side attractions of tax havens will diminish significantly. Tackling the offshore issue is a primary concern since the widespread public awareness of how the 1 percent use offshore accounts undermines tax morale and reduces compliance further down the income scale. Reversing weak tax morale requires strong and high-profile action to convince the 99 percent that taxes aren't just for "the little people."

Once basic confidence in the fairness of the tax system is achieved, the focus can shift to implementing a broader tax-policy mix that is both more equitable and more conducive to pro-poor growth. A key goal at this stage must be to encourage unregistered traders and micro-businesses to join the formal economy and become taxpayers. There is no simple formula for achieving this. But a mix of policies including allowing access to micro-credit, assisting with registration and tax filing, and support with distribution and marketing, might provide an appropriate balance of incentives. It is also crucial that the tax-policy mix covers a wide spread of citizens, and does not fall disproportionately on small and micro businesses. While there is no one-size-fits-all tax-policy mix that suits the needs and circumstances of all countries, certain principles need to underlie the choices that determine the choice of tax regime. These principles include:

- Choosing taxes that contribute to a long-term development strategy, and rejecting taxes that undermine the chosen strategy;
- Recognizing that taxes operate as a package rather than in isolation from each other;
- Creating a balanced tax regime based on a wide mix of taxes, including taxes on income, capital gains, wealth, property, and sales, rather than relying on only one or two sources of revenue income;
- Providing appropriate incentives for environmental protection;
- Avoiding taxes that require a considerable administrative input or are overly complex for micro-businesses.

In addition to the above principles, it is necessary to take account of the imperative to empower African citizens to hold their governments to account on both how taxes are raised and how the revenues are spent. The principles of tax justice require that

[4] http://www.taxjustice.net/cms/upload/pdf/AIE_100926_TJN-Briefing-2.pdf

citizens are actively engaged in tax policy formulation, in budgetary processes, in expenditure monitoring, and in promoting the efficiency, equity, and transparency of revenue collection processes. These are the foundations on which Africans can build a sustainable tax justice consensus.

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