FINANCING AFRICA'S STRUCTURAL TRANSFORMATION:

The Role of Development Finance Institutions in Promoting Responsible Taxation and Development

TAX JUSTICE
NETWORK
AFRICA

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About TJNA

The Tax Justice Network Africa (TJNA) is a Pan-African organisation and a member of the Global Alliance for Tax Justice. Launched in January 2007 during the World Social Forum (WSF) held in Nairobi, TJNA promotes socially-just, accountable and progressive taxation systems in Africa. It advocates for tax policies with pro-poor outcomes and tax systems that curb public resource leakages and enhance domestic resource mobilisation.

TJNA aims to achieve these by challenging harmful tax policies and practices that on one hand facilitate illicit resource outflows and on the other hand favour the wealthy while aggravating and perpetuating inequality. TJNA strives to promote the role of tax justice in the African Development Agenda. It further endeavours to provide a platform dedicated to enabling African researchers, campaigners, civil society organisations, policy makers, and investigative media to co-operate and synergise their efforts in the struggle against illicit financial flows, tax evasion, tax competition and other harmful tax policies and practices.

TJNA engages in various activities that are aimed at promoting public awareness regarding tax issues in Africa. Through networking among member organisations across Africa, TJNA seeks to raise awareness on the importance of taxation as a tool for development and enhancing democratic governance and to consolidate the efforts by CSOs to work on tax.

MISSION
To spearhead tax justice in Africa's development by enabling citizens and institutions to promote equitable tax systems through research, capacity-building and policy-influencing.

VISION
A new Africa where tax justice prevails and ensures equitable, inclusive and sustainable development.

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List of Abbreviations

AfDB	Africa Development Bank
AU	African Union
CAADP	Comprehensive Africa Agriculture Development Programme
CFTA	Continental Free Trade Area
DFI	Development Finance Institutions
DRM	Domestic Revenue Mobilisation
ECDPM	European Centre for Development Policy Management
FDI	Foreign Direct Investment
FfD	Financing for Development
IFC	International Finance Corporation
KI	Key Informants
MDGs	Millennium Development Goals
MoFPED	Ministry of Finance, Planning and Economic Development
MNCs	Multinational Corporations
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OOF	Other official flows
SDG	Sustainable Development Goals
SSA	Sub-Saharan Africa
TJNA	Tax Justice Network Africa
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNECA	United Nation Economic Commission for Africa

Abstract

Taxation is one of the key components of domestic revenue mobilisation since it is a reliable source of revenue for governments to fund public services for their citizens. Other alternative sources of finance such as Official Development Assistance (ODA) and Foreign Direct Investment (FDI) have been negatively affected by the on-going global financial liquidity challenges and have increasingly become very unreliable not to mention the conditions through which they are awarded. On this basis tax revenue has been fronted as the key component of domestic revenue which is necessary in financing sustainable development in the post 2015 development agenda.

Economic and social development is a long-term undertaking. Development Finance Institutions (DFIs) while playing their role of bridging the funding gap they remain in a better position to promote responsible taxation and development in the countries where they operate. Investors also have an obligation to respect human rights by acting responsibly, particularly in tax matters, businesses and investors can help improve the rule of law and thus reduce the scope for corruption. This paper explores the dynamics of financing Africa's structural transformation while examining the role of DFIs as an engine of responsible taxation and development. Using purposive interviews to compliment the literature review, it was found that DFIs play a critical role in achieving Africa's structural transformation. Trade misinvoicing, tax-base erosion and profit-shifting in developing countries among other negotiated tax incentives were found to be avenues through which resources are misdirected away from financing for development in developing countries.

To curb these vices, DFIs should practise **responsible lending** by encouraging beneficiary investors to practice **responsible taxation** by upholding transparency, accountability and fairness in their respective investments.

JEL Classification Numbers:
E62, H20, H26, H27, H71.

Key words:
Financing, Structural, Transformation, Taxation, Development.

1.0 Introduction

In the year 2000, the world set itself eight global targets which should have been achieved by 2015. The goals, popularly known as the Millennium Development Goals (MDGs) were to be financed through Foreign Direct Investments (FDI), international debt and Official Development Assistance (ODA) among others.

ODA in particular has played an important role in supporting basic humanitarian and development assistance in the poorest countries but it only plays a relatively small role in sustaining growth in countries that have graduated from low income status[1]. However, increased government spending on servicing international debt has diverted financing from development projects. (Development Finance International, Oxfam, 2015)

Although significant achievements were made on many of the MDG targets worldwide, progress was uneven across regions and countries, leaving significant gaps that needed attention (United Nation, 2015). In order to bridge these disparities, a post-2015 development agenda popularly referred to as the Sustainable Development Goals (SDGs)/ Agenda 2030 (United Nation(1), 2015) was adopted.

The Agenda 2030 has 17 goals which are geared towards ending poverty and hunger, and to achieve sustainable development in its three-pronged approach of promoting inclusive economic growth, protecting the environment and promoting social inclusion. It is estimated that an extra annual financing between USD 500 billion to USD 3 trillion on top of what is already being spent on the MDGs will be required to reach the SDGs (Brett, 2015).

The post-2015 development framework requires that the primary responsibility for economic and social development rests with every individual country[2]. This requirement has been emphasised in the Addis Ababa Action Agenda which provides that domestic revenue mobilisation is a key impetus to financing sustainable development. These new goals put great emphasis on a development model where the private and public sectors have complementary roles in supporting sustainable growth and improving lives of citizens (European Development Finance Institution, 2016).

On the basis of the funding challenges that were experienced in implementing MDGs, it has been proposed that SDGs can be well financed through: doubling tax revenue, radically overhauling global tax rules, doubling concessional development cooperation, improving tax allocation and effectiveness and raising about USD 500 billion in public innovative financing[3] (Development Finance International & Oxfam, 2015).

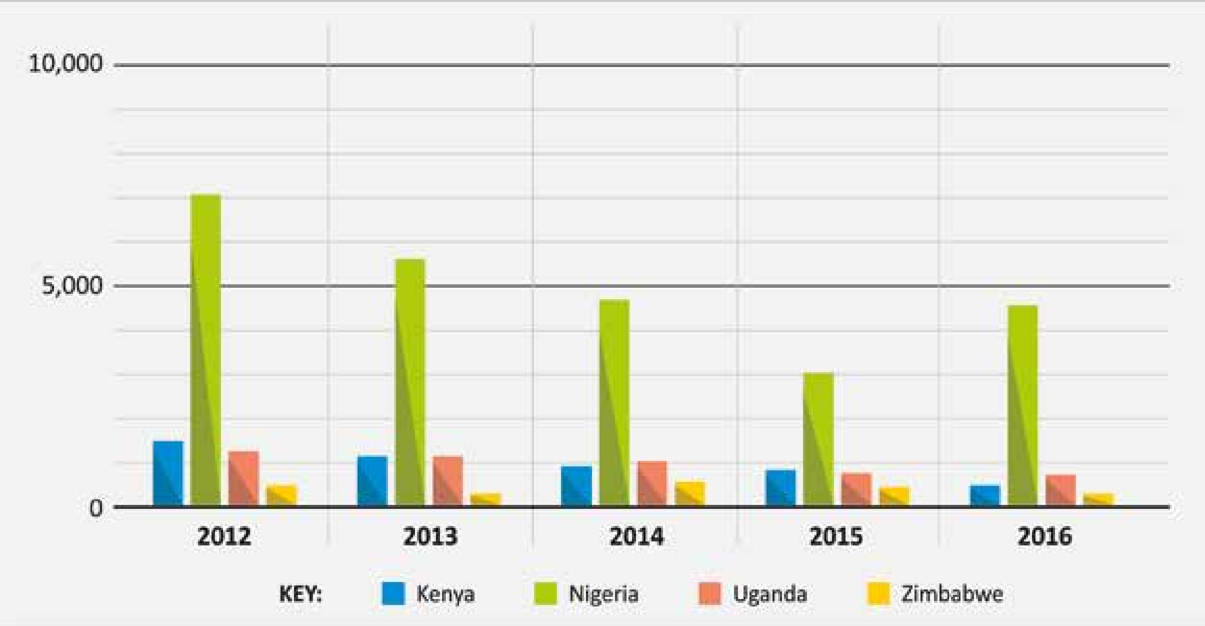
To contribute to the proposed forms of financing, this paper reviews the role of development financing institutions as a form of innovative financing and responsible taxation with a view of financing Africa's structural transformation. DFI investments in the private

1 EDFI flagship Report 2016
2 http://www.un.org/sustainabledevelopment/development-agenda/
3 Complementary to Official Development Assistance

sector are highly considered as a complementary to traditional official development assistance, which is typically focused on investments through the public and not-for-profit sectors (Dalberg Global Development Advisors, 2010). Equally DFIs are aimed at filling the gaps in domestic fiscal and long term-lending capabilities of under-developed and developing countries. They seek to address the capital market inefficiencies where private capital is unwilling or unable to bear the risk of providing capital to countries, projects or clients that are not considered creditworthy (Lewis et al, 2004).

The figure below shows a trend in inward FDI over a five year period for four sampled countries.

Figure 1: FDI - Inward Flows for Select African Countries



Source: Author's analysis (using UNCTADSTAT data)

2.0 Approach and Methodology

The motivation for this paper is to answer two broad questions: (i) Do DFIs have a role to play in responsible taxation and (ii), to what extent are DFIs relevant for Africa's structural transformation.

In trying to answer these two questions, the paper explored existing literature and conducted Key Informant Interviews (KI)[4].

The selection sample for the participants for the KI was purposive to further discuss emerging issues from the literature review. Of interest were some continental frameworks and processes as the paper questioned the role of DFIs in responsible lending as part of financing for Africa's structural transformation.

[4] The interview covered people with in-depth knowledge on the operations of DFIs

3.0 Literature Review

Since the mid-1990S, most sub-Saharan African countries have experienced unprecedented economic growth. This has mainly been attributed to macroeconomic management reforms and an improved business environment. However, the economic growth experienced is not itself enough to bring about sustainable development in the respective countries. In addition to economic growth there is a need for countries to promote and practice structural development (African Centre for Economic Transformation, 2014). These sentiments have been reiterated by the UN Secretary-General's High-Level Panel on the Post-2015 Development Action Agenda which recommends that it can only be realistic for countries to lift one billion people out of poverty not only by growing their national economies but with structural changes in the world economy (United Nations, 2013).

One of the key commitments by the member countries of the Addis Ababa Action Agenda is to prioritise projects with the greatest potential for promoting full and productive employment and decent work for all, sustainable patterns of production and consumption, structural transformation and sustainable industrialisation, productive diversification and agriculture. Further, what Africa needs is structural transformation and not structural adjustment.

Box 1: Structural Transformation

There has been no clear definition of what structural transformation is. However, AfDB,OECD,UNDP and UNECA(2013) as well as AEO (2016) define structural transformation as the process of moving economic resources from low to higher productivity activities. On the other hand, structural transformation is defined as the reallocation of economic activity across all sectors of an economy that accompanies the process of modern economic growth (Berthold, Richard & Akos, 2013). In the context of this paper structural transformation entails mutating of production systems from one dominated by primary extraction and low value-added goods and services, to one in which high value is added through the application of technology, innovation, beneficiation, better linkages between sectors in the wider economy as highlighted in (Pan African Parliament et al., 2013).

The Agenda 2063 is a continental framework that emphasises the need for structural transformation of Africa. It outlines the aspirations of the African people which can be achieved through the seven drivers of growth by 2063 (Africa Union, 2014). This is Africa's comprehensive endogenous plan for structural transformation and a shared strategic framework for inclusive growth and sustainable development.

According to the European Centre for Development Policy Management (ECDPM), significant efforts have been made to map the untapped alternative sources of financing from within Africa. This shows that significant resources could be raised from within Africa, enough to cover about 70% of the development financing needs (Fassi and Aggad, 2014). Relevant to this paper is the first aspiration of *"a prosperous Africa based on inclusive growth and sustainable development"*. The United Nations (2012) owns that one of the weaknesses of the MDGs was that in the global debate, the MDGs led to overemphasising of financial resource gaps to the detriment of the attention needed for institution-building and structural transformation.

3.1 Role of Development Financial Institutions and Taxation

According to Massa (2011), investment by DFIs play a positive and significant role in fostering economic growth in recipient countries, with a stronger impact in lower-income countries than in higher-income countries. Development Finance Institutions (DFIs) are government-supported institutions that invest in private and public sector projects in low and middle income countries in order to promote job creation and sustainable economic growth (The Association of Bilateral European Development Finance Institutions, 2018)[5].

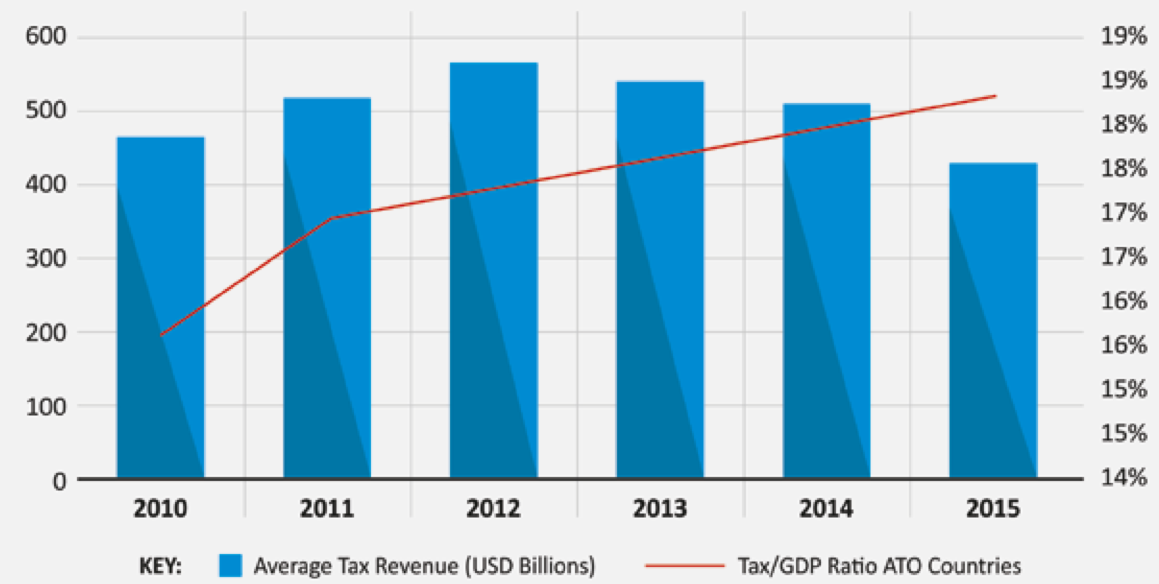
DFIs can be categorised as both national and international specialised development banks or subsidiaries set up to support private sector development in developing countries. They are usually majority-owned by national governments and source their capital from national or international development funds or benefit from government guarantees[6]. These institutions finance projects in support of the private sector through mainly equity investments, long-term loans and guarantees. DFIs through this form of investments act as catalysts of tax revenue in the countries of investment.

Box 2: Other Official Flows

Other Official Flows (OOF) are defined as official sector transactions that do not meet Official Development Assistance (ODA) criteria. OOF include: grants to developing countries for representational or essentially commercial purposes; official bilateral transactions intended to promote development, but having a grant element of less than 25%; and, official bilateral transactions, whatever their grant element, that are primarily export-facilitating in purpose. This category includes, by definition, export credits extended directly to an aid recipient by an official agency or institution (official direct export credits); the net acquisition by governments and central monetary institutions of securities issued by multilateral development banks at market terms; subsidies (grants) to the private sector to soften its credits to developing countries; and, funds in support of private investment. This indicator is measured in millions of USD, using 2014 as the base year.[7]

5 https://www.edfi.eu/about-dfis/what-is-a-dfi/
6 http://www.oecd.org/dac/stats/development-finance-institutions-private-sector-development.htm
7 https://data.oecd.org/drf/other-official-flows-oof.htm

Figure 2: Tax Revenue and Tax GDP Ratio Trends



Source: Africa Economic Outlook Report 2017 & Africa Tax Outlook (ATO[8]) Report 2017

The figure above shows trends of domestic tax revenue reported by African countries and Africa tax GDP Ratio reported by Africa Tax Administration Forum (ATAF) member-countries.

It is evident that there is a declining trend in the average tax revenue reported by African countries and that the Africa Tax Outlook (ATO) members have reported an increasing trend in the tax to GDP ratio over time.

These mixed trends portray the challenges that African countries experience in the domestic resource mobilisation agenda and subsequently the aspect of structural transformation. On the other hand table 1 shows trends in tax revenue collection, annual budget and FDI inflows for the period 201- 2017 in Uganda.

The increasing trend in tax revenue collection for Uganda is promising and worth supporting the debate for domestic resource mobilisation. Tax revenue is the only sure source for financing a national budget. When tax revenue grows at a slower rate, it means the country's annual budget will mainly be financed by external sources like FDI, international debt and ODA. A good mix of domestic revenue coupled with external support in the form of targeted FDI, ODA and remittances will help finance a

8 ATO countries include: Botswana, Benin, Burundi, Cameroon, Gambia, Kenya, Lesotho, Liberia, Mauritius, Mozambique, Nigeria, Rwanda, Senegal, Seychelles, South Africa, Swaziland, Tanzania, Togo, Uganda, Zambia and Zimbabwe.

Table 1: Trend in Tax Revenue, Annual Budget, FDI Inflows & Net ODA, 2012/13-2016/17

UGANDA	2012/13	2013/14	2014/15	2015/16	2016/17
Tax Revenue Collected (Billion UGX)	6.9	7.4	8.3	10.1	11.4
Annual Budget (Trillion UGX)	10.2	12.55	14.3	15.054	23.972
FDI Net Inflows (Million USD)	1,205	1,096	1,059	538	523
Net Official Aid Received (Million USD)	1642.5	1697.09	1633.68	1628.2	1757.13

Source: Author's analysis, data source (URA, MoFPED, UNCTADSTAT, Index mundi)

country's structural transformation.

The issues discussed may not be relevant without discussing the importance of the report of the UNECA High Level Panel on Illicit Financial Flows. The report reveals that illicit financial flows out of Africa have become a matter of great concern because of the scale and the negative impact of such flows on Africa's development and governance agenda. The report estimates that, illicit flows from Africa could be as much as USD 50 billion per annum. This is approximately double the Official Development Assistance that Africa receives and, indeed, the estimate may well be short of reality as accurate data does not exist for all transactions and for all African countries (Africa Union and United Nations Economic Commission for Africa, 2015)[9].

The report identifies activities relating to: corruption, criminal and commercial operations as the main ways in which these illicit flows are funneled out of Africa.

3.2 Africa Structural Transformation and Taxation

The structural transformation dialogue has sought to promote economic development by shifting from low productivity economic activities to high productivity economic activities. For instance, the agriculture sector alone has huge potential to turn around the growth figures for the continent. Agriculture and agribusiness together are projected to be a USD 1 trillion industry in Sub-Saharan Africa (SSA) by 2030 (compared to USD 313 billion in 2010), and therefore they should be at the top of the agenda for economic transformation and development[10]. With a view of improving productivity, African governments have over time engaged in tax transition where neutral taxation systems have been replaced with protective tax systems (Brun & Chambas, 2015). Africa is endowed with fertile soils and good climate, providing a perfect environment for

9 The 4th Joint Annual Meetings of the AU/ECA Conference of Ministers of Finance, Planning and Economic Development adopted Resolution L8 mandating the establishment of a High Level Panel (HLP) on illicit financial flows. http://www.uneca.org/pages/iff-background

10 World Bank Report: *Growing Africa: Unlocking the potential of Agribusiness.* See: http://siteresources.worldbank.org/INTAFRICA/Resources/africa-agribusiness-report-2013.pdf

the cultivation of a majority of food and cash crop species. Investing in Africa's agribusiness will help jump-start economic transformation through development of agro-based industries. This will greatly spur growth, create much needed jobs and improve the quality of agricultural exports (World Bank, 2013). This is an area that DFIs can greatly invest in as it is the most promising sector for the future of Africa with a high trickle-down effect and significant forward and backward linkages with other economic sectors.

In 2003, the African Union (AU) and New Partnership for Africa's Development (NEPAD) initiated the Comprehensive Africa Agriculture Development Programme (CAADP). This is the most ambitious and comprehensive agricultural reform effort ever undertaken in Africa. It represents a fundamental shift towards the development of a policy framework that is fully owned and led by African governments. It reflects African governments' recognition of agriculture as central to the alleviation of poverty and hunger thereby achieving the Millennium Development Goals (MDGs)[11].

The post 2015-2025 agenda is an effort for the inherent CAADP implementation process to sustain the momentum. This is captured in the CAADP Momentum Results Framework (2015-2025). This enables Africa to have tangible parameters to benchmark advancements in agricultural performance while at the same time reinforcing a culture of results-based programming, results for evidence and objective analysis as well as concerns about aspects such as returns on investment[12].

Limited financing and failure to adopt the best practices on improving of productivity, have been fronted as the main challenge towards promoting Africa's structural transformation. There is need to put in place policies geared towards encouraging productive capabilities that support a wide range of sectors like infrastructure, market access through regional cooperation, or skills development, among many others (Fuenfzig, 2017). To maximise the gains, proposals for financing and development partnerships should be assessed from three perspectives: first, from the point of view of evidence discernible from recent trends for the different financing modalities; second, from a political economy perspective as regards state-citizen relations and accountability; and, third, from the point of view of their contribution to economic, social and sustainable development-related transformational agendas for the continent (Abugre & Atieno, 2015).

The Post 2015 agenda requires that the primary responsibility for economic and social development is the sole obligation of every individual country. To finance these responsibilities, Domestic Revenue Mobilisation (DRM) has been regarded as the most important and reliable ingredient[13]. This is because of the fact that (i) it potentially provides 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; (ii) it helps to strengthen fiscal institutions because stable and predictable

[11] http://www.future-agricultures.org/policy-engagement/caadp/547-what-is-caadp
[12] http://www.nepad-caadp.net/sustaining-caadp-momentum
[13] https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp022216#P76_12371

revenue facilitates long term fiscal planning which can help ensure that resources are allocated to priority sectors and are translated into outcomes; (iii) reliance on foreign aid flows can be very volatile and has the potential of aggravating the microeconomic development in developing countries; and (iv) foreign aid has the capacity to make most African countries oblivious of their potential wealth. DRM can be achieved through domestic borrowing, private investment and tax revenue. Taxation has remained the most reliable component of DRM considering the other options are prone and often affected by some external factors like exchange rates.

The Domestic Resource Mobilisation agenda remained a central part of the discussions during the 3rd Financing for Development (FfD3) conference held in Addis Ababa in July 2015. Tax revenues, in particular, could far exceed any other source of finance for Africa's development. External resources such as foreign aid, foreign direct investment or private money and loans can neither replace nor reduce the importance of tax[14] in financing sustainable development.

While tax revenues may be increasing for specific countries in Africa and that some countries are approaching the average OECD tax to GDP ratios of 35% in other African countries this ratio is still as low as 17% (African Development Bank, OECD and UNDP, 2014). The increasing tax revenue underscores the importance of Domestic Resource Mobilisation as the engine for financing Africa's structural transformation. In order to attain acceptable tax/GDP ratios there is need for a call for responsibility among taxpayers within and without a given country.

Responsible taxation is more than the amount of tax paid at the end of the year and is by no means the compliance status which companies can attain in the short-term. This paper looks at responsible taxation from the perspective of companies through consideration of not just how well tax behaviour links with profit maximisation in the short-term, but also how well it contributes sustainable development in the longer term. Thus, responsible taxation should be looked at as an ongoing process of transparency, assessment, progressive and measureable improvement in dialogue with a broader range of stakeholders than merely revenue authorities (Action Aid et al., 2015).

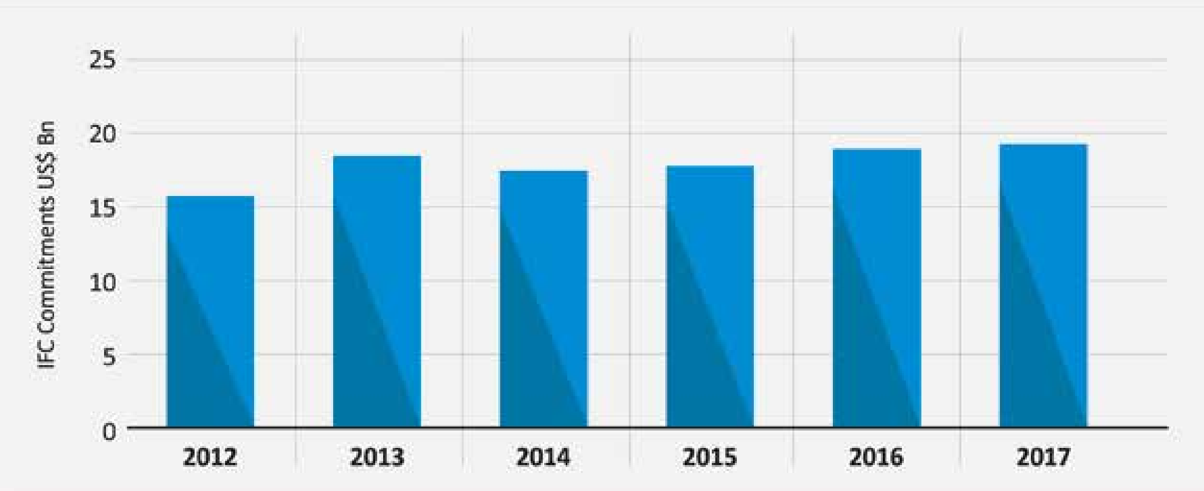
3.3 The role of Development Financing Institutions and Structural transformation

The widening gap between the investment needed and what is available to end poverty amounts to trillions of dollars each year, this trend has made the efforts towards ending poverty an expensive affair (IFC, 2017). The Private sector and its ability to solicit funds for development has been considered critical and has taken central place in the new development framework for most countries. To avail the much needed funds to private sector actors, Development Finance Institutions (DFI) have come in handy in bridging the funding gaps through building the platforms and creating the opportunities to foster development. However, it is worth noting the imbalance in power structures between the developed countries in

[14] http://www.tralac.org/images/docs/7727/outcome-document-third-international-conference-on-financing-for-development-addis-ababa-action-agenda-15-july-2015.pdf

which most DFIs are based and the developing countries where most of the financing is directed. This means, among other things, that multinational corporations from developed countries often receive the lion's share of contracts that are funded by such DFIs. On the other hand, investments are sometimes routed through tax havens, helping to legitimise their role in the loss of hundreds of billions of dollars to developing countries through tax dodging (Romero, 2014). For instance the volumes of DFI commitments from IFC over the years show a gradual increase from a low of USD 15.46bn reported in 2012 to a high of USD 19.32bn reported in 2017 (IFC Annual Reports, 2017).

Figure 3: IFC Commitments 2012-2017



Source: IFC annual reports

The increasing trend in commitment further emphasises the central role that IFC has been playing towards mobilisation of private capital for development which will be essential to achieve the Sustainable Development Goals.

To realise the Post-2015 Sustainable Development Goals, DFIs like IFC besides providing finance to private investors they should also promote responsible lending which takes into consideration that such investments should contribute to domestic revenues through payment of their fair share of tax. This therefore means piling pressure on companies with dodgy tax structures that facilitate illicit outflows of resources to adopt high degree of disclosure and transparency measures.

According to the IFC's annual report, the top five sectors based on their level of commitments in 2017 were: Financial Markets, Infrastructure, Agribusiness & Forestry, Manufacturing as well as Health and Education as seen in table 2.

Table 2: IFC Long term Commitments by sector in 2017

INDUSTRY	USD MILLIONS
Financial Markets	5,862
Infrastructure	1,705
Agribusiness & Forestry	1,155
Manufacturing	989
Health & Education	692
Oil, Gas, & Mining	435
Tourism, Retail & Property	429
Funds	356
Telecommunications &Information Technology	232

Source: IFC annual Report 2017

From industry allocation of International Finance Corporation (IFC) funding as illustrated in Table 2, it is evident that most of the funding has been directed towards the service industry, especially the financial sector, and minimal commitments have been towards other sectors like health and education. According to Romero (2014), the financial sector has been favoured by DFIs in recent years, receiving on average more than 50% of funding that has been allocated to the private sector. What this implies is that some sectors will remain underfunded and subsequently there will be slowed realisation of Africa's structural transformation. Good health and development of Africa's human capital through education and skill revolution have been identified as one of the key components to promoting inclusive and sustainable growth under Agenda 2063. DFIs' transparency to the general public is limited, which in turn constrains the ability of stakeholders to effectively exercise external control (Romero, 2014).

Even with increased levels of DFI funding some sectors are highly underfunded and as such there will be need for governments to look for other sources of finance to be channelled to these sectors. Responsible taxation by private sector players will play a key role in providing the state with the much- needed funds towards promoting structural transformation. Tax avoidance, tax evasion, aggressive tax planning and other tax abuse schemes like trade misinvoicing, transfer mispricing and other tax base erosion practices from beneficiaries of DFI funding and the struggle by governments to mobilise much-needed domestic resources to finance basic services have remained persistent in most developing countries. This paper is geared to demonstrate the role of DFI in Africa's structural transformation and how they can be agents of responsible taxation while advancing funds on the basis of the responses received from key informants and literature findings highlighted in the foregoing.

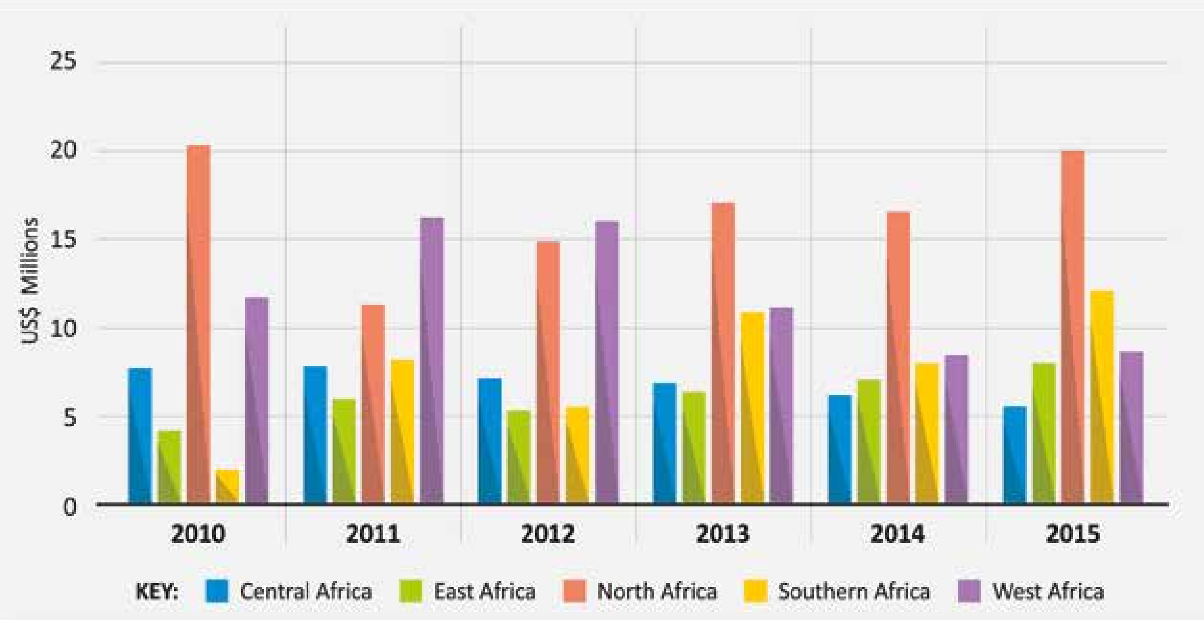
4.0 Data Analysis and Key Findings

Data examination covers the overall statistics for Africa and some selected countries where TJNA has members including Kenya, Uganda, Cameroon, Zimbabwe and Nigeria. The selection of the specific countries was based on criteria such as recent economic development, regional aggregation, political atmosphere and availability of data among other factors.

While FDI and ODA have remained important forms of financing Africa's development over the years, the levels of such funding have remained volatile and unpredictable as a result of the changing economic environment.

However, in line with the Addis Ababa Action Agenda there is dire need to review the means of financing Africa's development by moving from foreign sources of financing to local ones. Tax revenue has been seen as the most reliable and appropriate form of domestic financing as compared to other forms. The figure below shows the trends of inward foreign direct investment in Africa.

Figure 4: Regional Inward Flows of FDI to Africa

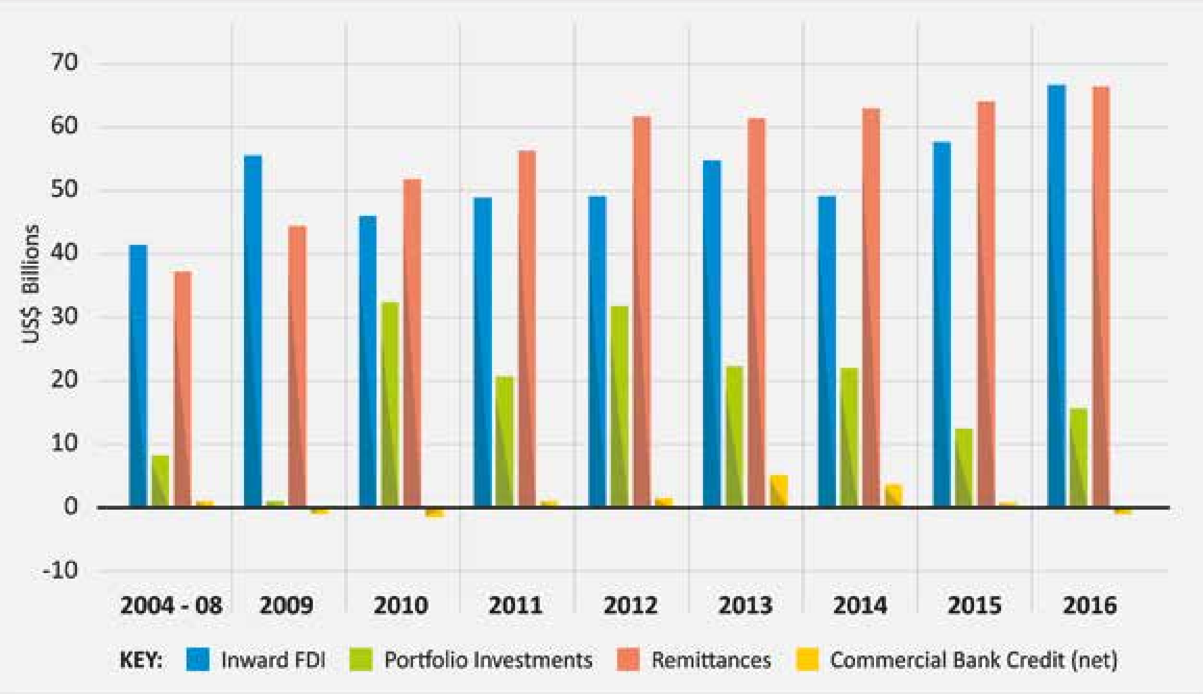


Source: Africa Economic Outlook 2016

From the above figure it is evident that North Africa received the highest FDI inflows directed to Africa. This was closely followed by Southern Africa with Central Africa reporting the lowest values of FDI inflows.

This trend confirms that most FDI are directed to resource- rich countries or regions which exhibit some level of political stability.

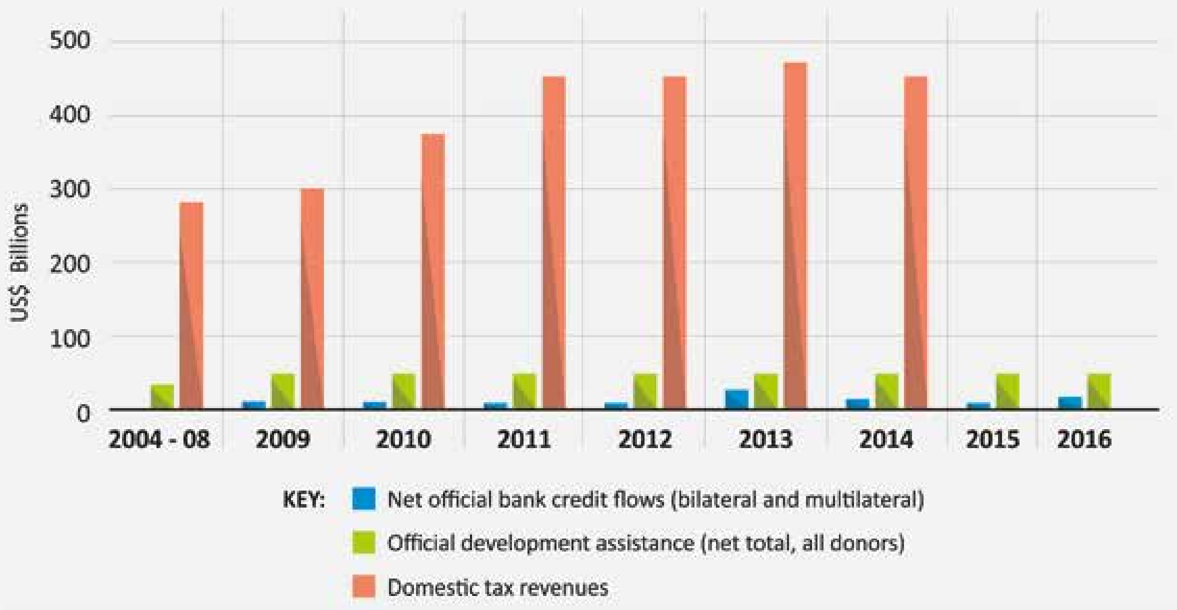
Figure 5: Private Financial Flows to Africa



Source: Africa Economic Outlook 2016

Private financial flows into Africa are mainly comprised of remittances and inward FDIs as detailed above. It is evident that remittances are increasing as compared with the FDI. This form of financing is very critical in reducing the reliance of foreign funding as the remittances do not require any repayment and thus the need for an all-inclusive responsible tax practices considering private firms are agents through which DFI distributes funds.

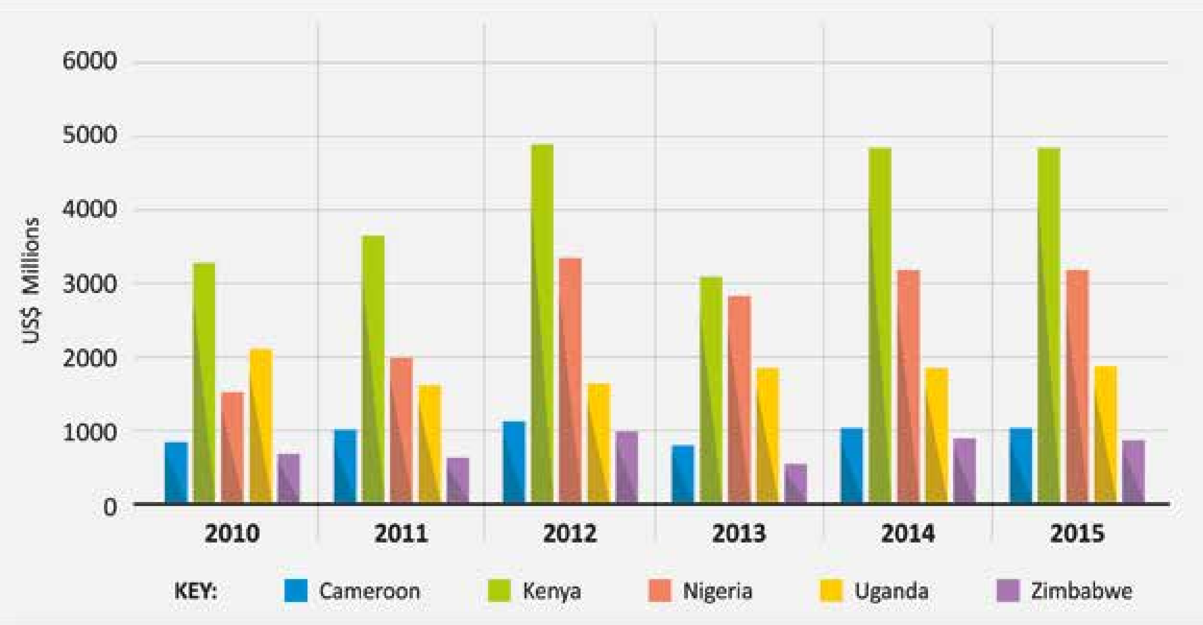
Figure 6: Public Financial Flow and Tax Revenue to Africa



Source: Africa Economic Outlook 2016

On the other hand domestic tax revenues as a form of public financial flows has show an increased trend over the years, however, it remained static in the period 2012- 2014. This is highly associated with fall in prices of natural resources and subsequently slowed generation of tax revenue. On the other hand, according to the Africa Economic Outlook Report (2016), countries dependent on commodities have experienced a drop in tax to GDP ratios across all categories compared to their counterparts which are not commodity rich.

Figure 7: ODA Flows for Selected Countries



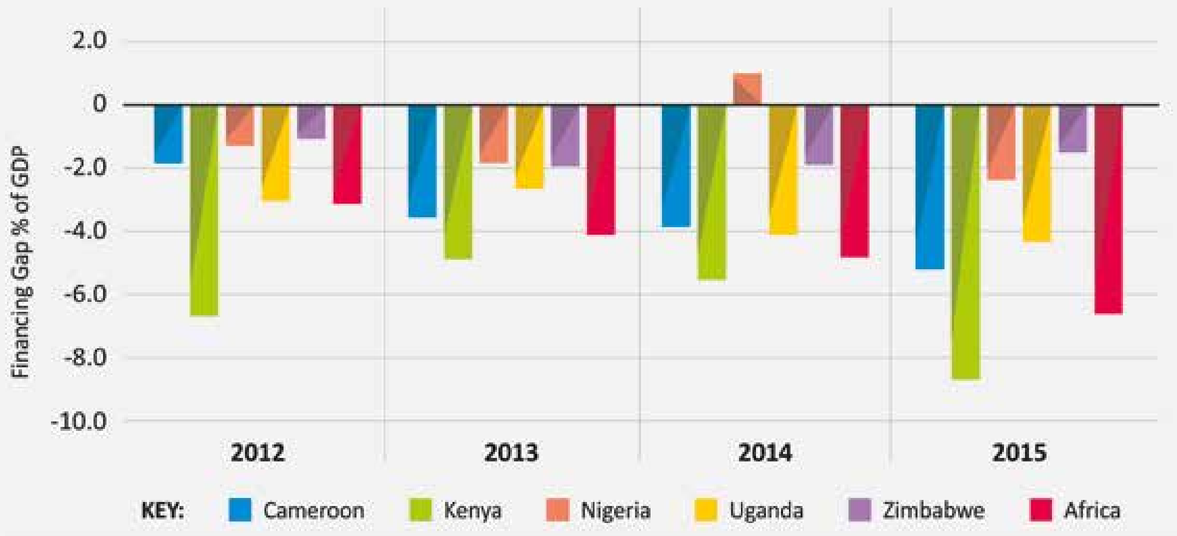
Source: OECD Statistics

The figure above shows the trends in ODA flows to the selected countries from 2010 to 2015. The various countries were selected on the basis of qualitative factors like geographical region, economic trends and the fact that TJNA has members in these countries. From the figure above, of the selected countries, Kenya received the highest amounts of ODA which has since shown a decline. Equally, there was an increase in ODA trends between the years 2010-2012, up to which there was a decline.

Based on the foregoing trends it is evident that tax revenue is an important component of domestic resources and subsequently critical in financing development for Africa. It is equally important to emphasise the fact that all the other forms remain important in bridging the financing gaps since the tax revenue does not cover all the government expenditure. With the widening financing gap and the volatility of the external sources of funding, there is need for Africa to mobilise more resources internally. The mobilised resources will be vital in promoting Africa structural development in line with Agenda 2063.

Figure 8 shows the financing gaps as a percentage of GDP reported by the selected countries over the years 2012- 2015.

Figure 8: Financing Gap as % of GDP for 2012-2015



Source: African Economic Outlook 2016

The figure above shows that there is an increasing financing gap in the selected countries and Africa as a whole. Of the selected countries, Kenya reported the highest financing gaps over the years compared to other states.

In line with the above summary of data analysis, the following findings were made as to why it is important for DFI to help developing countries in facilitating responsible taxation with a view of promoting Africa's structural transformation:

- Trade misinvoicing- this arises as a result of differences in recording of values in the exporting and importing countries. This is an illegal activity, designed to evade tax and foreign exchange payments. According to the Mbeki Report on Illicit financial flows, trade misinvoicing is costing some commodity-dependent developing countries up to 67% of their export earnings. Trade misinvoicing is hampering economic growth and potentially resulting in the loss of billions of US dollars in tax revenue in some developing countries. This kind of practice ends up denying the respective governments the tax revenue that would in many countries exceed their inward Foreign Direct Investment. The net effect is that this is a leading driver of illicit financial flows from Africa.

Table 3 shows a case of misinvoicing in select African countries.

Table 3: Cases of Trade Misinvoicing of Primary Commodities in Select African Countries

COUNTRY EXPORTING	COMMODITY EXPORTED	TRADING PARTNER	PERIOD	LOSS INCURRED (US$ BILLIONS)
South Africa	Gold	India, Germany, Italy & UK	2000-2014	78.2
Nigeria	Oil	US	1996-2014	69.8
Zambia	Copper	Switzerland	1995-2014	28.9
Cote d'Ivoire	Cocoa	Netherlands	1995-2014	5
South Africa	Iron Ore	China	2000-2014	3

Source: Author's digest of excerpt from "Trade Misinvoicing in Primary Commodities in developing countries"

Trade misinvoicing is thought to be one of the largest drivers of illicit financial flows from developing countries, so that the countries lose precious foreign exchange earnings, tax, and income that might otherwise be spent on development[15]. Evidence from the table above shows that these losses originate from the mining sector and it deprives these countries of the much needed foreign currency to finance development. This was according to a recent report released during the UNCTAD's Global Communities Forum in Nairobi Kenya (July 2016). According to the UNCTAD's Secretary-General, Dr. Mukhisa Kituyi, commodity exports may account for up to 90 percent of a developing country's total export earnings. He added that the study generated fresh lines of enquiry in understanding the problem of illicit trade flows.

- Commodity dependent developing countries lose more during commodity price bust.

Dependence on corporate tax payments is especially acute in countries where the extractive industries supply a large share of government tax and non-tax revenues. A fall in commodity price would directly lead to a fall in revenue mobilisation as companies in some cases shut down their plants due to the losses. The lack of linkages between the extractive sectors to value addition activities and diversification of their revenue streams further emphasises the magnitude of the loss. Investing in value addition would create the much needed jobs for the youth and result in a trickle-down effect of reduced inequality, poverty reduction and economic growth. It is worth noting that 30% of the global reserves of raw materials are found in Africa. If handled well, the sector can be a major driving force for economic growth on the continent by creating employment opportunities and boosting tax revenues.

- It should be noted that most multinational

[15] http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=1277

corporations do not hire locals as senior managers. Secondly the top management are usually over-paid in terms of salary and benefits thus creating a wide gap in remuneration between the highest paid and lowest paid in the organisation thus facilitating inequality. The high salaries equally form a huge component of the running costs and subsequently impact on the reported profits negatively. Thirdly, most MNCs have dodgy structures that allow them to hide what could normally be declared as profit. These structures allow them to trade amongst subsidiaries. In the long-run, the inflation of the company's costs erodes all the profits, thereby having a long term impact on the host country's ability to raise the necessary revenue. Important to note is limited manpower in most developing countries to decipher this structural arrangement and above all the political will to invest in these skills.

> ***"In the face of the current growing global challenges especially in developing countries, DFIs have a fundamental role in promoting sustainable growth and development…"***

- Tax incentives, both negotiated and ordinarily available tax incentives have emerged as a topic of corporate responsibility, because they represent lost tax revenues which are needed for the financing of the Sustainable Development Goals (SDGs). There are over 300 tax treaties in Africa, and the Civil Society is calling for a stop to the negotiation of new treaties. There is also a valid call to review the terms contained in some of the treaties as well as the scrapping of some of the out-dated ones. Africa as a continent can benefit even more under the Continental Free Trade Area (CFTA). Alternatively, regions can sign treaties among themselves and improve the ease of doing business to attract investments both locally and internationally.

- Tackling illicit financial flows (IFFs) from Africa is a priority. IFFs out of Africa are high and have been increasing over time, depriving Africa of important resources for development finance. Between 1970 to 2008, Africa lost USD 1 trillion[16]. The report by the High Level Panel on Illicit Financial Flows put the loss at over USD 100 billion annually compared to about USD 41.6 billion received annually in ODA.

  Of all these losses, 65% comes from the extractive sector. This phenomenon makes Africa a net creditor to the world. According to Mr Tirivangani Mutazu, a Senior Policy Analyst at AFRODAD, *"Structural transformation remains a key agenda in Africa and DFIs have a role in promoting responsible lending that is geared towards bridging the financing gap necessary to the transformation agenda"*. This view does not come as a surprise, given the growing trend of DFIs in directing their funding towards service sector, especially the finance sector. This sector has been highlighted as one of the major facilitators of IFFs (commercial activities).

[16] Illicit Financial Flows from Africa, Hidden Financial Resource for Development. http://www.gfintegrity.org/storage/gfip/documents/reports/gfi_africareport_web.pdf

- DFIs are increasingly funding huge projects across Africa under Public Private Partnerships (PPPs). Whilst this is very good, the challenge observed is that the private investors involved in these projects majority of whom are Multinational Companies are not contributing their fair share of taxes in the countries in which they are operating. This is mainly attributed to aggressive tax planning practices which are facilitated by the broken international financial tax system. This has been reiterated in the Mbeki Report, which points out that 65% of IFFs are contributed by commercial transactions by MNCs. This form of transfer pricing is commonly known as tax avoidance.

  Whilst this is legal according to the letters of the law, it may not necessarily be moral. This is in the sense that if they (MNCs) avoid paying their fair share of tax it has a huge negative impact on developing countries' citizens, livelihoods as governments fail to provide for basic public amenities. The idea of responsible taxation therefore comes into play because it then calls for companies to look at both the legal and moral aspects of their tax planning practices.

  The big role for DFIs in this case is to come up with assessments criteria for MNCs in terms of their tax practices and level of compliance as a basic standard in determining whether to advance them financing or not. This move will bring an impetus to promoting responsible tax practices on the part of private businesses and consequently value add to the DRM process.

With the increased funding from DFIs and taking note of the above key findings, there is need for DFIs to champion for responsible taxation practices by companies and private investors who benefit from such funding. Responsible tax will widen developing countries' domestic revenue collection, which could then be deployed to finance social needs and development goals such as provision of quality and accessible education and basic healthcare for all.

Given the harmful impact of tax dodging on developing countries and the fight against tax avoidance and evasion finally gaining momentum, connected with the need for the structural transformation of Africa, DFIs should be expected to be at the forefront with safeguards and policies to ensure responsible tax policies and practice from their partners in the private sector. Civil society groups have called on DFIs several times to adopt and enforce progressive policies and abide to the highest level of corporate transparency.

5.0 Conclusion and recommendations

The structural transformation of economies remains an important agenda in Africa towards achieving Sustainable Development Goals.

Conclusion
DFIs have a significant direct and indirect impact on the developing countries in which they operate. DFIs help bridge the financing gap which is vital for structural transformation. Funding from DFIs is usually in the form of loans, equity, quasi equity instruments and guarantees. DFIs provide funds, either as equity participation, loans or guarantees, to foreign or domestic investors. These investors will initiate or develop projects in sectors or in countries in which the traditional commercial banks are reticent to invest in without some form of official involvement. DFIs are equally fundamental in the SME sector (small and medium enterprise) where micro loans, traditionally viewed as high-risk, form the bulk of investment activity.

These contributions are a major impetus for financing the Post-2015 agenda to achieve the 17 SDGs. When DFIs help finance SMEs, they have a direct and sustainable impact on development. This role should be performed with the courtesy of reminding companies (MNCs) to pay their fair share of tax.

Policy Recommendations

- To play the major role of facilitating responsible taxation in their funding process, DFIs should have among other exclusions a clause which provides for no funding to any investors whose tax compliance is not up to date and that they should put in place publicly accessible tax policies. This can be easily administered by calling for presentation of tax compliance certificate of the beneficiary entity and all its affiliated entities.

- There is need to subject to scrutiny the terms of government exchange notes on DFI funding considering that most DFIs are government-supported and that most funds are directed at public projects. The scrutiny will help in ensuring that the terms agreed upon do not deprive the state of its right to tax some aspects of the investment or extend unfair tax advantages compared to local investors in similar projects.

- DFIs should practice responsible-lending (avoid selective lending) and support indigenous companies and also motivate investors to invest in all sectors of development. Where possible, this funding should go through as on-budget support through a government-fund basket. This will allow it to be reported as additional official development assistance. DFIs should play the role of carrying out a due-diligence assessment on the investors seeking for funding with a view of ensuring the diversified portfolio of investments hence promoting the Africa structural transformation agenda.

- Tax-responsible companies should only accept tax incentives that are equally offered to competitors (level playing field) and under democratic scrutiny. They should refrain from engaging in stability clauses or other instruments that lock incentives in for the long term without options for reviews and revisions. Consider the case of Apple Inc.'s operations in Ireland in which the MNC is said to have struck sweetheart deals' with the Irish tax authority which consequently led to non-payment of the rightful tax[17].

- Tax responsible companies should be transparent about which tax incentives they receive, for how much and how long in various countries. They should also explain what impact not receiving this incentive would have on their ability to do business and ensure that auditing of the use of the incentive for the agreed purpose is ensured.

- Use of third-party jurisdictions, tax treaties and corporate structure - There is need for the disclosure of all subsidiaries or structures investors make use of and key account data for their activities (country by country reporting). A tax responsible business would explain the rationale of its presence in a secrecy jurisdiction as well as act on dismantling subsidiaries in order to reduce the number of inactive subsidiaries in secrecy jurisdictions.

- Private sector investments by DFIs should only be on the basis of transparency, accountability and fairness on the part of the companies.

[17] http://www.publicfinanceinternational.org/news/2016/08/european-commission-orders-apple-pay-eu13bn-unpaid-tax

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