The Case for Domestic Resource Mobilisation in the Context of Economic Recovery

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Will There Be Continued Stagnation of Domestic Revenue During Recovery?

- This presentation is based, in part, on the CDPR Discussion Paper:

  '*Is Stagnation of Domestic Revenue in Low-Income Countries Inevitable?'*,

  McKinley and Kyrili 2009, www.soas.ac.uk/cdpr
- This paper examined revenue trends in low-income countries in sub-Saharan Africa and Asia for 1990-2006
- It found that though revenue-to-GDP levels increased more rapidly in the 2000s, the general increase over 1990-2006 was modest
- The paper places the blame on the conventional advice given on designing tax policies

The Neglect of DRM in the MDG Framework, Pre-Crisis

- The MDG Framework generally emphasised a <u>'Big Push'</u> in scaling up ODA to accelerate development in low-income countries, leading, for example, to the Gleneagles promise of a 'doubling of aid' to SSA
- The UN Millennium Project's 2005 Report to the UN Secretary-General, *Investing in Development*, did recommend an increase of domestic financing for the MDGs of 4 percentage points of GDP over 2006-2015, namely, over 10 years
- Hence, most of the public financing for the MDGs was assumed to be external, not domestic, and heavily reliant on grants

Domestic Resource Mobilisation in the MDG Framework, Pre-Crisis

- The 4 ppts increase is a modest yardstick
- We slightly increased this yardstick to 5 ppts and applied it, retroactively, to the period 1990-2006 in order to assess progress
- This would be an easier goal, of course, for a country increasing revenue from 10% to 15% of GDP than for a country increasing it from 15% to 20%
- The yardstick represents moderate ambition, an improvement over generally static analyses—e.g., ‘did the VAT recover revenue lost from trade liberalisation?’

Domestic Resource Mobilisation During the Onset of the Crisis

- Revenue-to-GDP of 20% is desirable and attainable but a level below 15% is unacceptable
- Few low-income countries in SSA have reached the threshold of 20% and some that had attained it earlier fell below it before the crisis
- The Great Recession has led to a contraction of revenue because of the decline in incomes (affecting both direct and indirect taxes)
- Some governments have lowered tax rates, such as on such higher-priced items as fuel and food (because of the external price shocks)

Domestic Resource Mobilisation During the Onset of the Crisis

- The IMF has allowed some expansion of fiscal deficits but domestic financing has been more prevalent than external financing ('Creating Fiscal Space', Sept. 2009)
- Domestic financing in 2009 was likely 6 times as large as external financing (e.g., resorting to domestic debt or drawing down foreign-exchange reserves)!
- The IMF has favoured the use of 'automatic stabilisers' but mainly on the revenue side (even though revenue-to-GDP ratios are already low)
- Namely, revenues were allowed to fall more than expenditures (leading to a weak fiscal stimulus)

Domestic Resource Mobilisation During the Onset of the Crisis

- Automatic stabilisers on the expenditure side, such as social safety nets: virtually non-existent
- Consumption taxes are likely to have suffered the largest declines in revenue
- Revenues from resource exports likely the hardest hit (they were the fastest growing prior to the crisis)
- Should Tax Rates be reduced to provide Fiscal Stimulus?

A. Main beneficiaries, especially for direct taxes, would be richer groups
B. Already low levels of revenue would be even lower going forward
C. The stimulus effect would be weak and belated

Will Domestic Revenue Continue to Stagnate in African LICs post-crisis?

- Let us assume that global economic recovery is underway
- This is based on assuming no 'W-shaped' or 'Double-Dip' Great Recession driven by another developed-country downturn
- Developing countries have weathered the storm better than expected, based in part on the robust recovery of growth in major emerging markets, such as China (10% proj. growth in 2010), India (8%), Indonesia (5-6%) and Brazil (5%)
- Sub-Saharan Africa did not, in aggregate, suffer recession and is projected to regain a regional growth rate of 4.7% in 2010 and 5.9% in 2011 (WEO, April 2010 Update)

2008	2009	2010	2011
5.5%	2.1%	4.7%	5.9%

How Can SSA Countries Boost Domestic Revenue Mobilisation?

- Assuming growth of 5-6% in sub-Saharan Africa, how can revenue grow faster than income in the coming period (raising revenue-to-GDP ratio)?
- In order to boost revenue by at least 5 percentage points over the next 10 years
- Will revenue from commodity exports (oil, copper, gold, diamonds) regain their previous growth rates?
- Will trade liberalisation be accelerated, lowering trade taxes?
- Will corporate (and personal) income tax rates continue to be lowered?

What Was the Pre-Crisis Record of Revenue Mobilisation?

- Why did domestic revenue tend to stagnate prior to the global crisis?
- Why was progress not more rapid during the 2000s, when growth and trade accelerated?
- By closely examining IMF national-level statistics, we constructed an initial data base of revenue and its major components for 1990-2006
- Our main objective was to assess the relative progress among revenue’s main components, particularly trade taxes, direct (income) taxes and indirect (consumption) taxes

What Was the Pre-Crisis Record of Revenue Mobilisation?

- We use 2006 as the end point because disaggregated data by component were still available for that year
- We group data into averages for three periods—1990-94, 1995-99 and 2000-06—in order to highlight sustained progress, not temporary oscillations
- We use the yardstick of 5 ppts increase in revenue/GDP
- In this presentation we will highlight the results for 29 low-income countries in sub-Saharan Africa
- But we will compare the results for the African countries with those for 7 low-income countries in South-Southeast Asia (Bangladesh, Cambodia, India, Lao PDR, Nepal, Pakistan and Vietnam)

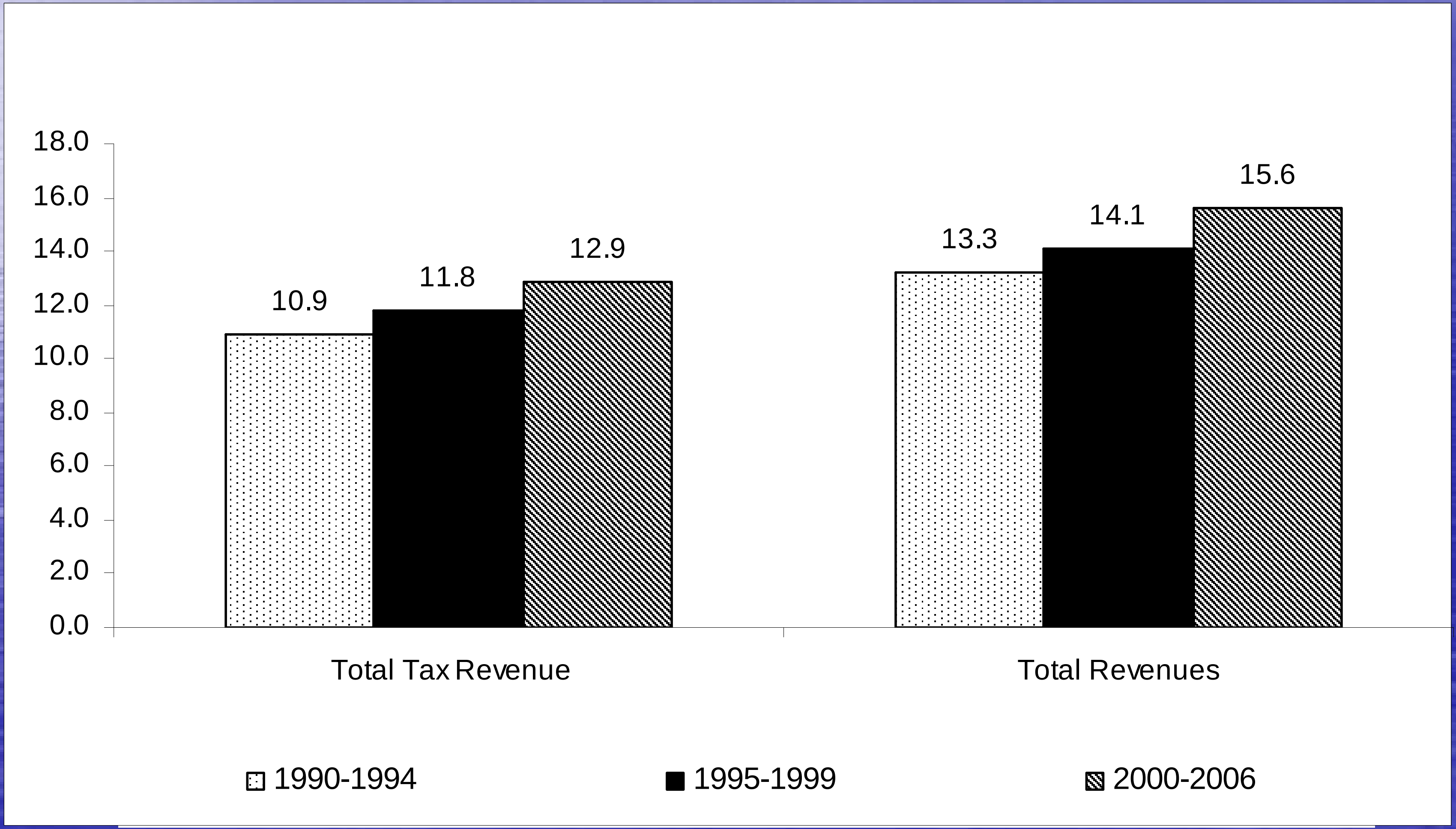
Trends in Total Revenue for African LICs, 1990s-2000s

- Among the 29 African LICs, total revenue increased from 13.3% of GDP in 1990-94 to 15.6% in 2000-06
- This is an increase of 2.3 ppts—less than half the 5 ppts yardstick
- Progress was about twice as fast between 1995-99 to 2000-06 as during the 1990s
- But the 2000s were a period of significantly more rapid growth of GDP (5.5%) as well as trade

Trends in Tax Revenue for African LICs, 1990s-2000s

- Non-Tax Revenue increased very little between the 1990s and 2000s: 0.3 ppts (partly reflecting resource rents)
- Tax Revenue increased from 10.9% of GDP during 1990-94 to only 12.9% during 2000-06
- This was a mere 2 percentage points over such a long period of time
- <u>Tentative Assessment</u>: unsatisfactory progress on revenue mobilisation through the mid 2000s
- Was this due simply to slow growth of incomes or poor design of tax policies?

Sub-Saharan African LICs Revenue Trends (% of GDP)



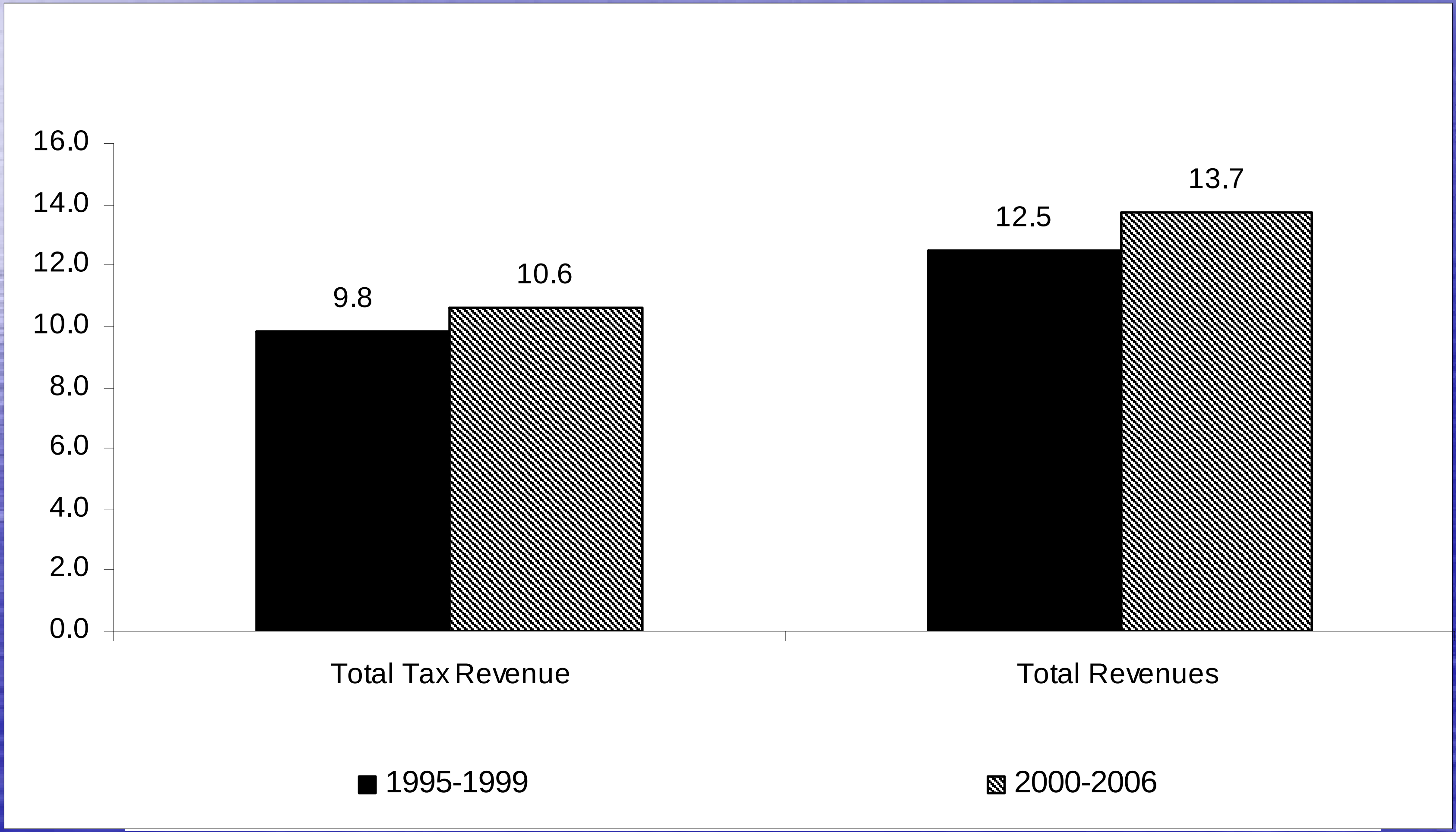
Diverging Theories and Explanations of Revenue Mobilisation

- There has been a conservative 'small-state' paradigm at work for a while: taxes are an inherent 'disincentive' to private initiative
- Keynesians regard taxes as contingent on income increases, which are contingent on aggregate demand ('investment determines savings')
- In either case, there is not a strong motivation to <u>directly</u> and <u>pro-actively</u> try to boost public revenue
- Moreover, scaled-up ODA should be used to fill the savings gap (the MDG 'Big Push' strategy)

How Does Revenue Mobilisation of Asian LICs Compare to that of African LICs?

- We are only able to compare trends for 1995-99 and 2000-06 because of lack of data for Asian LICs: So we adopt a simple 3 ppt yardstick
- Surprisingly, levels of both total revenue and tax revenue are comparatively low in Asia
- Total revenue in Asia increased slowly: from 12.5% of GDP in 1995-99 to only 13.7% in 2000-06, or by only 1.2 ppts!
- And Tax Revenue in Asia increased from 9.8% of GDP to only 10.6%, or by only 0.8 ppt (with Non-Tax Revenue accounting for the other 0.4 ppt)

South-Southeast Asian LICs Revenue Trends (% of GDP)



What Are the Trends in the Components of Tax Revenue?

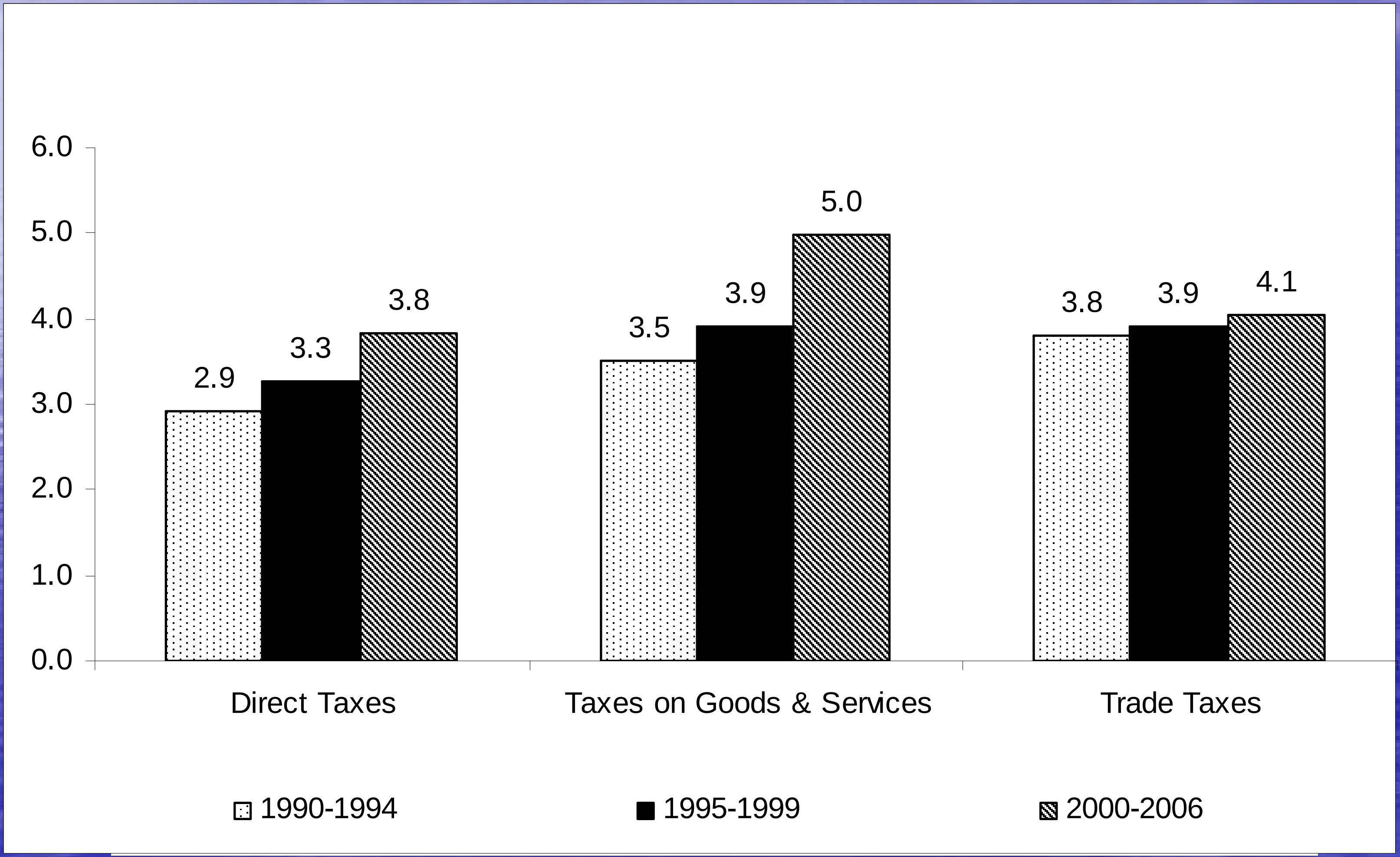
- We begin our search for an explanation of slow progress in revenue mobilisation by examining trends in the major components of tax revenue:

1. Has trade liberalisation led to slow or negative growth in trade taxes?
2. Has the lowering of corporate (and personal) income tax rates led to slow progress in direct taxes?
3. Has the Value Added Tax helped to boost revenue from indirect (consumption) taxes?

Tax Component Trends in SSA Low-Income Countries

- Domestic indirect taxes (on goods & services) rose the <u>most rapidly</u>, by 1.5 ppts: from 3.5% of GDP to 5.0%
- Direct taxes (corporate & personal income) rose by less, 0.9 ppt: from 2.9% of GDP to 3.8%
- Trade taxes (mainly tariffs) rose by only 0.3 ppt: from 3.8% to 4.1% (despite a significant increase in imports as a % of GDP)
- So, indirect taxes performed credibly, but not strongly enough to overcome slow growth in direct taxes and stagnation in trade taxes

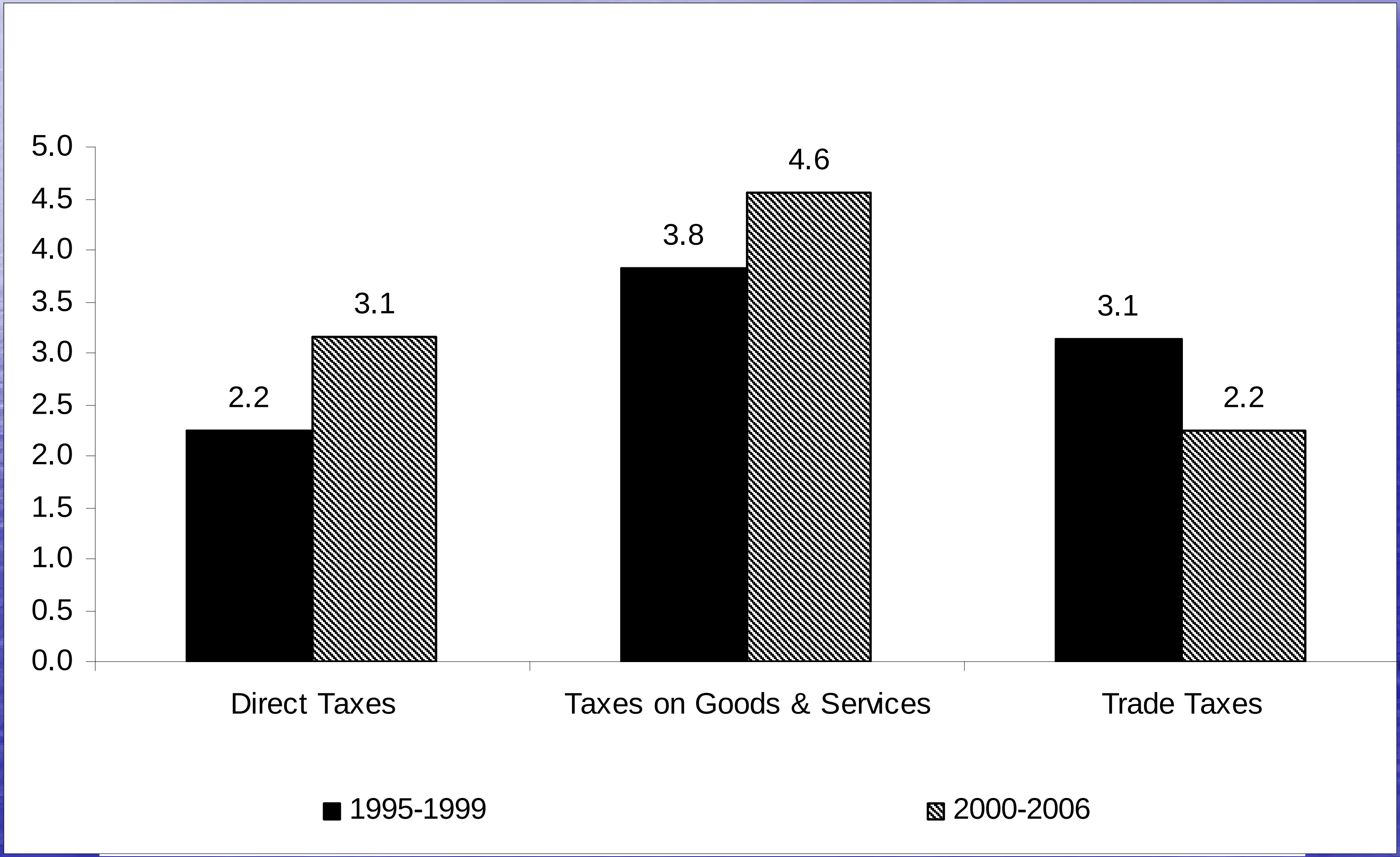
Sub-Saharan African LICs
Tax Component Trends (% of GDP)



Tax Component Trends in South-Southeast Asian LICs

- Domestic direct taxes increased faster in Asia than in Africa: from 2.2% of GDP to 3.1%, or 0.9 ppt (1995-99 to 2000-06)
- Domestic indirect taxes increased by 0.8 ppt, from 3.8% of GDP to 4.6%--about the same rate as in Africa
- But trade taxes <u>declined</u> by 0.9 ppt, from 3.1% to 2.2%, despite a significant rise in imports
- There was faster growth in Asia (driving up domestic and indirect taxes) but also greater trade liberalisation (lower-level trade taxes)

South-Southeast Asian LICs Tax Component Trends (% of GDP)



Country-Level Performance in Sub-Saharan African LICs

- Only five LICs in SSA boosted total revenue by 5 ppts between 1990-94 and 2000-06:
  - Sudan, Mauritania and Guinea-Bissau did so mostly from resource revenues (oil; fishing rights)
  - Rwanda did so from a low starting-point: 6.4% of GDP in total revenue
  - Only Ghana achieved notable success: with increases across all three components (total: 14.2% of GDP to 21.6%)
  - Implication: successful DRM strategies relied on either resource rents or diversification of revenue sources

Country-Level Performance in South-Southeast Asian LICs

- Only Vietnam can be considered as a success story in South-Southeast Asia
  - It increased its total revenue from about 19% of GDP to about 24% (i.e., 5 ppts)
  - It benefited from oil revenues: namely, taxes on corporate profits and (non-tax) royalty fees
  - But it also diversified its revenue sources, with regionally high direct taxes (8.2% of GDP) and above-average trade taxes

Some Concluding Remarks

- The general picture of Domestic Resource Mobilisation is not encouraging
- Taxation of natural resources has played a major role in most successful cases
- Other sources (Keen & Mansour 2009) suggest no upward trend in non-resource taxes in the 2000s
- For those countries lacking such resources, the only other viable general strategy appears to be diversification of sources

Some Concluding Remarks

- Relying mostly on dynamism in domestic indirect taxation (VAT)—the standard advice—poses severe challenges
- Especially since lowering corporate tax rates does not appear to have broadened the base and thereby helped boost direct taxes
- Trade liberalization has taken a toll on revenues, but more so in Asia:
- What will happen if SSA further liberalizes trade; and it cannot garner large gains from the VAT?