FINANCING AFRICA'S STRUCTURAL TRANSFORMATION: THE ROLE OF DEVELOPMENT FINANCE INSTITUTIONS IN PROMOTING RESPONSIBLE TAXATION AND DEVELOPMENT

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Abstract

Tax is a sustainable tool for domestic revenue mobilisation and provides the much needed revenue for governments to fund public services for their citizens. Other alternatives of revenue such as Official Development Assistance and Private finance (FDI) have been negatively affected by the ongoing global financial liquidity challenges and have increasingly become very unreliable not even mentioning the conditions they are usually associated with. Taxation is one of the key answers to the post 2015 development agenda.

Economic and social development is a long-term undertaking. Development Finance Institutions (DFIs) are very crucial in promoting responsible taxation and development in the countries where they operate. It is through respecting, protecting and fulfilling civil, political, economic, social, cultural and environmental rights that the state earns its legitimacy to tax. Businesses also have a responsibility to respect human rights and by acting responsibly, particularly in tax matters, business 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 key informant interviews to compliment the literature review, the following are the results: Trade misinvoicing costing some commodity dependent developing countries up to 67% of their exports; high cost of tax base erosion and profit shifting in developing countries in both the short-run and long-run; both negotiated and ordinarily available tax incentives have emerged as a topic of corporate responsibility and tackling illicit financial flows from Africa remains a

priority. Ultimately, DFIs should practice responsible lending to discourage irresponsible borrowing from the private sectors and governments in Africa.

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Introduction

Taxation is the most reliable and sustainable source of revenue for any government to finance public expenditure such as health, education, water, sanitation, infrastructure and other social amenities. Without adequate resources, rights to basic amenities and social services such as health and education will remain mere aspirations. Revenue from taxation is therefore critical for the fulfilment and realization of the economic, social and cultural rights of citizens. External resources such as foreign aid, foreign direct investment or private money and loans can neither replace nor reduce the importance of tax[1]. Tax remains the most reliable and sustainable source of financing for economic development and poverty eradication. On the other hand, tax is not only a tool for resource mobilisation but it has a direct and indirect impact on poverty and inequality. A progressive and redistributive tax policy enables a country to adequately address poverty and inequality. A regressive tax policy puts disproportionate tax burden on the poor and the less well-off, provides tax incentives and creates tax loopholes which result in tax avoidance and tax leakages which result in the poor bearing the greatest burden of taxation. According to the African Tax Administration Forum, up to one-third of Africa's wealth is being held abroad and is beyond the reach of African tax authorities, thus depriving African countries of resources that could be used to mitigate inequality[2].

Motivation and Methodology

In terms of motivation and methodologies, this paper set to explore two major questions. To what extent is financing Africa's structural transformation of importance? Secondly, do DFIs have a role to play in responsible taxation and development? In trying to answer these two questions, the paper explores existing literature and conducted key informant interviews (KI). The selection sample for the participants for the KI was purposive to further discuss emerging issues from the literature review. This further enriched the results of the study.

Literature Review

In the year 2000, the world sets itself eight global targets by 2015 in what is known as the Millennium Development Goals. After its expiration, the post 2015 agenda led to another seventeen goals-Sustainable Development Goals (SDGs). The post 2015 framework requires that the primary responsibility for economic and social development is the sole obligation of every individual country and consequently Domestic Resource Mobilisation is viewed as the most important source in financing the SDGs. To

[1]Seehttp://www.tralac.org/images/docs/7727/outcome-document-third-international-conference-on-financing-for-development-addis-ababa-action-agenda-15-july-2015.pdf
[2]Report of High Level Panel on Illicit Financial Flows - Commissioned by the AU/ECA Conference of Ministers of Finance, Planning and Economic Development

discuss financing the Africa structural transformation, this paper will concern itself with explaining who the DFIs are, what they fund and linking this to some continental frameworks and processes.

According to OECD, DFIs can be categorized 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[3]

DFIs can be either bilateral or multilateral. The multilateral DFIs include: the International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB). Multilateral DFIs provide a broad selection of financial services, ranging from loans and guarantees to investors and entrepreneurs to equity participation in firms or investment funds (Isabella Massa, 2011). DFIs fund both the private and public sector and this paper will focus mainly on the multilateral DFIs.

That notwithstanding, private sector investments by DFIs have grown rapidly over the past decade, with annual global commitments rising from $15.4 billion in 2003 to $21.4 billion in 2005 and $33 billion in 2009. DFIs support is now equivalent to a quarter of official development assistance (ODA), although much of it is not counted as ODA but as Other Official Flows (ODI, 2011).

DFIs and other development banks could also be instrumental in funding the post-2015 development agenda in Africa. Europe will have to adjust and probably strengthen the role of the European Investment Bank (and the European Bank for Reconstruction and Development) and seek greater coordination and coherence with member states' development finance institutions and other development cooperation mechanisms. The potential of African DFIs and regional development banks could also be better harnessed. At the international level, this will be important for effective operationalisation of global funds, such as the UNFCCC's Green Climate Fund and the World Bank's newly established Global Infrastructure Facility, which seek to increase the pool of resources for global sustainable development (UNEP, 2013). With a few exceptions, recipient countries have a long way to go in establishing attractive vehicles for these funds (Lopes, 2014).

Top of the list for the continental frameworks and processes is the agenda 2063. This is a continental framework that outlines the aspiration of the African people, the seven drivers of agenda 2063. The agenda 2063 is Africa's comprehensive endogenous plan for structural transformation and a shared strategic framework for inclusive growth and sustainable development. According to 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 biggest question is how Africa can achieve an inclusive growth and sustainable development. Well this may be possible in part if the continent can implement and monitor the Africa Mining Vision, a framework that was adopted by the Africa Union Heads of States in February 2009.

The Africa Mining Vision is a holistic framework that advocates for the African countries to think outside the mining box. The framework reiterates that it is the full responsibility of Africa to tackle the paradox of great mineral wealth existing side by side with extreme poverty. This therefore means that mining should

[3] http://www.oecd.org/dac/stats/development-finance-institutions-private-sector-development.htm

be carefully integrated into development policies at national and regional level. This leaves us with the responsibility of improving mining regimes to ensure that tax revenue from mining are optimized[4].

This means figuring how best mining can contribute to development at three levels: local; national and regional. At local levels, communities ought to benefit from large scale industrial mining and ensure that their environment is protected. At national level, countries should better negotiate contracts with mining multinationals to achieve fair resource rents and encourage absorption of local inputs for operations. At the regional level, it is important to harmonize the mining into industrial and trade policy. This is one framework if implemented accordingly will see the opening out of mining's enclave status so that Africa can move from its historic status as an exporter of cheap raw materials to manufacturer and supplier of knowledge-based services. This is one approach of financing Africa's structural transformation.

This paper cannot be complete 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 major concern because of the scale and 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 US $50 billion per annum. This is approximately double the official development assistance (ODA) 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[5]. In what is now known as the 3Cs, the report identifies corruption activities, criminal activities and commercial activities as ways in which these resources leave Africa illicitly.

Structural transformation is therefore the reallocation of economic activity across the broad sectors of agriculture, manufacturing and services. Agriculture and agribusiness together are projected to be a US$1 trillion industry in Sub-Saharan Africa (SSA) by 2030 (Compared to US$ 313 billion in 2010), and they should be at the top of the agenda for economic transformation and development[6]. Africa is gifted with fertile soil and good climate, investing in Africa's agribusiness will help jump-start economic transformation through development of agro-based industries. This will greatly spur growth, create the much needed jobs and improve the quality of agricultural exports (value addition) (World Bank Report, 2013). This is an area that DFIs can greatly invest 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.

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. C and Atieno. N, 2015)

Tax revenues, in particular, could far exceed any other source of finance for Africa's development. While tax revenues are increasing in Africa and some countries are approaching OECD tax to GDP ratios of 35% in other African countries this ratio is still as low as 17% (African Development Bank, 2014). The

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[4] The Africa Mining Vision was adopted by Heads of State at the February 2009 AU summit following the October 2008 meeting of African Ministers responsible for Mineral Resources Development.
http://www.africaminingvision.org/amv_resources/AMV/Africa_Mining_Vision_English.pdf

[5] 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

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

increasing tax revenue underscores the importance of Domestic Resource Mobilisation as the engine for financing Africa's Structural Transformation.

Findings

Structural transformation of economies is the agenda in Africa. This leaves no option but to reiterate the important role that Domestic Resource Mobilisation can play in financing Africa's structural transformation. The paper presents the following results:

- Trade misinvoicing costing some commodity dependent developing countries up to 67% of their exports. Fraudulent misinvoicing of trade is hampering economic growth and potentially resulting in billions of US dollars in lost tax revenue in some developing countries. A study released by UNCTAD reveals that between 2000 and 2014, under-invoicing of gold exports from South Africa amounted to 78.2 billion U.S. dollars, or 67 percent of total gold exports[7]. 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 shuts down their plants due to the losses. These countries should invest in linking their extractive sectors and diversify their revenue sources. Unfortunately, DFIs are willing to invest in extractive companies but unable to invest in small and medium enterprises (SMEs) for value addition. Intra-Africa trade of up to 40% is only in value addition. Investing in value addition would create the much needed jobs for the youth and the trickle-down effect on inequality, poverty reduction and economic growth. It is worth noting that 30% of the global reserves of raw materials are here 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.

- High cost of tax base erosion and profit shifting in developing countries in both the short-run and long-run. It should be remembered that most Multinational corporations don't hire top management from the local country of operation. Secondly the top management usually earn abnormal salary and benefits. Thirdly, most MNCs have a dodgy structure that allows them to hide what could normally be declared as profit. This structure allows them to trade amongst themselves. In the long-run, the inflation of the company's cost erodes the would be profit having a long term impact on the host country, deterring their ability to raise revenue. Unfortunately, there is limited manpower in most developing countries to decipher this structural arrangement and above all the political will to invest in these skills.

- Both negotiated and ordinarily available tax incentives have emerged as a topic of corporate responsibility, because they represent major lost tax revenues which are needed for financing the newly agreed Sustainable Development Goals (SDGs). There are over 300 treaties in Africa, with urgent call from mainly the civil society organisations to stop negotiation new treaties. There is also a valid call to the terms of some of the treaties as well as scrapping some of the outdated one. Africa as a continent can benefit even more under the Continental Free Trade Area (CFTA). Alternatively, regions can sign treaties among themselves and improving 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 overtime, depriving Africa from important resources for development finance. Between 1970-2008, Africa lost about a trillion US$. The report by the UNECA High

[7]Trade Misinvoicing in primary commodities in developing countries: The case of Chile, Cote d'voire, Nigeria, South Africa, and Zambia.

Level Panel on Illicit Financial Flows put the loss at over US$ 50 billion annually compared to about US$ 41.6 billion received annually in ODA. Of all these losses, 65% comes from the extractive sector. Natural resource which is a finite resource contributes more to IFFs. This phenomenon makes Africa a net creditor to the world.

- DFIs are increasingly funding huge projects across Africa under Public Private Partnership (PPPs). Whilst this is very good, the challenge being observed is that the private companies involved in these projects which are mainly Multinational Companies (MNCs) 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 an tax system (This is also clearly highlighted in the Mbeki led HLP Report on IFFs, that 65% of IFFs are contributed by commercial transactions by MNCs' aggressive tax planning practices). 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. Moral in the sense that if they MNCs avoid paying their fair share of tax it has 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 important 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 of MNCs in terms of their tax practices as a standard to finance them or not and this will promote responsible tax practices on the part of private businesses. This will therefore go a long way in ensuring that MNCs pay their fair share of taxes to contribute to domestic revenue mobilisation.

Conclusions

Financing Africa's structural Transformation is an important agenda for Africa. DFIs have a significant direct and indirect impact on developing countries in which they operate. 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

- DFIs should practice responsible lending, avoid selective lending and support indigenous companies. Where possible, these funding should go through an on budget support through a government fund basket. This will allow it to be reported as additional official development assistant.

- Tax responsible companies should only accept tax incentives that are equally offered to competitors (level playing field) and under democratic scrutiny and refrain from engaging in stability clauses or other instruments that lock incentives in long term without options for reviews and revisions;

- Tax responsible companies should be transparent about which tax incentives they receive, for how much and how long in various countries. 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; and

- Use of third jurisdictions, tax treaties and corporate structure. The 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.

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