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The illusion of tax expenditures in Africa

Anne-Marie Geourjon
Grégoire Rota-Graziosi [1]

Anne-Marie Geourjon, Senior Fellow Ferdi, member of the tax experts Panel at the International Monetary Fund. She is specialized in taxes issues.

Grégoire Rota Graziosi, Fiscal Affairs Department, International Monetary Fund, and CERDI-CNRS, Université d'Auvergne.
Email: grotagraziosi@imf.org

Introduction

Tax expenditure is transfer of public funds resulting from a reduction of tax obligations in relation to a standard, rather than direct spending (OECD, 2010). This definition relies to two conditions, which characterize tax expenditure: (1) a reduction in government tax revenue, and (2) a deviation from the tax norm, called the benchmark tax system, which must be defined. Tax expenditure is an alternative to public spending. Its assessment is a component of budget transparency. [2]

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1. The opinions expressed in this document are those of the author and cannot be attributed to the International Monetary Fund, its executive board or its executive directors.
2. Besides budget transparency, the publication of tax expenditures improves relations between central and local governments. This quality may explain why federal countries were the first to make estimates of these expenditures. Indeed, some exemptions or rate reductions granted by the central government concern local taxes, such as the "patente," which is often exempted in most of Sub Saharan African (SSA). investment codes.

•••/••• The German Federal Republic evaluated first tax expenditure in 1966. The United States followed in 1968, when the US Treasury published the first budget with tax expenditure. This practice expanded in all OECD countries with varying degrees of strictness, before becoming global. In Africa, the assessment of tax expenditures is more recent: Morocco, South Africa, Senegal, Benin, and the member states of the East African Community (EAC) have published some evaluations since the early 2000s.

Tax expenditures assessment for Sub Saharan African (SSA) countries is particularly important, since the mobilization of domestic tax revenue is a high priority in a context of trade liberalization and limited capacity of borrowing.[3] Moreover, developing countries are particularly exposed to the risk of two types of tax expenditure, although their efficacy has never been clearly established: the proliferation of derogatory tax regimes to attract investments and tax and tariffs exemptions as a reply to rising food prices.

On the one hand SSA countries have competed to a certain extent to attract foreign direct investments, through generous derogatory tax regimes deviating significantly from their respective standard tax system.[4] On the other hand, recent booms of international food prices and sporadic crises have led these countries to temporarily or permanently exempt most of these products from all customs and taxes, in the hope of reaching a reasonable price at the domestic market.

The aim of this policy brief is to point out the illusory nature of some tax expenditures, and to show that in SSA their assessment can be seriously misleading.

Tax expenditures: an illusory costless way for public finance

Tax expenditures may generate an illusion of a costless or less costly way to finance some public spending than direct expenditures. This yields mainly from the lack of their rigorous assessment. Without such estimation, the risk of a proliferation of tax expenditures is certain. Several of these expenditures are a direct result of the logic of collective action in line with Olson (1965): small and well-organized lobby groups obtain some tax advantages to the detriment of a silent majority. Other tax expenditures are equivalent to price subsidies for some goods, although the efficiency of targeting the poorest inhabitants through such a mechanism is rarely/never established.

The lack of effort when it comes to evaluate tax expenditures may be intentional, since the absence of any information contributes to the illusion that a few incentives and exemptions do not have a significant budgetary impact. The aim of publishing tax expenditures is specifically to eliminate this illusion.

Nevertheless the task of estimating tax expenditures remains difficult for several reasons. First of all, it requires the definition of a benchmark tax system for each country, which takes into account its international commitments too. It is then necessary to define a strict evaluation methodology, which means having access to tax and customs data. These issues explain the large variations in tax estimations between countries, from one year to the next, or even from one government to the next in the same country.[5]

3. Trade liberalization leads to a reduction of revenue on international transactions. Domestic revenue mobilisation is seen not only as an obvious means to finance public spending, indispensable to economic development, but also as the guarantee of a better governance (cf. Brautigam et al. 2008).
4. See for example Mansour and Rota-Graziosi (2014) for the WAEMU member states.
5. During the last attempt to fundamentally restructure the American tax system, the matter of tax expenditures was perceived very differently by Democrats and Republicans. The former considered tax expenditures to be on the same footing as direct expenditures, whereas the Republicans saw in tax expenditures a means to render the American tax system more effective.

The overestimation of tax expenditures: the illusion of a potentially recoverable loss of revenue

If the evaluation and publication of tax expenditures participate to good public finance management, they should not lead to over-estimation, which would generate another illusion in terms of tax revenue expectations in case of the suppression of a specific tax expenditure. The method usually consists in calculating the income shortfalls, relative to if the tax exemption or reductions had not taken place. This method, which has the advantage of being simple, assumes the absence of reaction from the taxpayer. In other words, investment and consumption are hypothetically identical, with or without tax or customs advantages. Eliminating these advantages therefore does not automatically involve a tax revenue gain equal to the corresponding tax expenditure. In order to avoid the over-estimation of this gain, it would seem appropriate to integrate investor's or consumer's behavior (for example by taking into account the opportunity cost of capital or the elasticity of demand for a good with respect to price its price).

Two relatively frequent errors maintain the illusion of tax expenditures (see table 1 for some examples based on public information):

1. A first mistake, which can be of crucial importance in terms of GDP, concerns the VAT exemption collected at the border on capital goods imported by companies for example under the Investment Code.[6] This VAT exemption on capital goods, or also potentially on inputs does not mean that the goods produced by these companies are exempt from VAT. The customs exemption is therefore not a loss of revenue but simply a cash flow facility allowed by the state. It certainly introduces a tax expenditure, which is very low in regards to the sums that are usually referred to, since it concerns the advanced cash flow conferred by this kind of exoneration.[7]

2. A second error consists in considering as tax expenditure the exemptions allowed for diplomatic missions in accordance with the Vienna Convention.[8] These exemptions are in fact subject to international law and should therefore be integrated to the benchmark tax system.

Belonging to a regional integration area increases the risk of overestimating tax expenditures. SSA countries, which belong to a customs union (for example: WAEMU, CAEMC, and EAC) usually, and rightly, regard the common exterior tariff (CET) as the tax norm. However, exemptions of indirect taxes (custom duties or VAT [9]), which derive from these customs unions are sometimes considered, wrongly, as tax expenditures, although they apply to member states.

In SSA countries, the assessment of tax expenditures is generally performed by tax and customs administrations rather than by a specific structure in the ministry of finance, which encourages overestimation. In fact, it is in these

6. These companies therefore belong to the formal sector and are generally organized in corporations (legal persons). One of the most obvious mistakes is to regard the VAT exemption on the import of capital goods by a mining and oil company as a loss of revenue. These companies' output is generally destined for export and therefore subject to a zero VAT rate. The payment of VAT at customs on capital goods would then imply the refund of VAT excess credits.

7. A good illustration would be to consider that the VAT exemption on the importation of capital goods for a mine as a tax expenditure when this exporting mine is subject to a zero VAT rate in a standard tax system and would have to be refunded the VAT paid on its inputs.

8. Article 36 of this international convention provides for the exemption of duties and taxes for objects destined for official use in a diplomatic mission, and objects destined for the personal use of the diplomatic agent and their family.

9. For example the exemption of customs duties provided for in the fifth annex of the law on customs and border management in the EAC.

administrations' interest to overestimate these expenditures for at least two reasons. First, higher are tax expenditures, less accountable are customs and tax administration for their weak performance in terms of revenue mobilization. This relationship is also valid in the case of revenue agencies. For customs and tax administrations or revenues agencies, an overestimation of tax expenditures is a way to hide the weakness of their weak performance in terms of collection. The second reason relies to the management procedures of these administrations. Indeed, their remunerations are based for a significant part on some performance assessments, which is linked to the amount of taxes and tariffs effectively collected at the borders. Thus, customs used to have an estimation of revenue losses before any tax expenditures assessment has been considered by the authorities. This explains why VAT exemption at the border has often been assimilated to tax expenditure.

The over-estimation of tax expenditures maintains the illusion of significant potential future revenue increases. In SSA countries where the improvement of tax revenue mobilization is a recurring preoccupation, this illusion risks, more than elsewhere, resulting in disappointments, or even some political tensions.

Table 1. Some examples of tax expenditures and their illusions (percent of GDP)

	Year	Tax expenditures	Tax expenditures linked to VAT	VAT exemptions on imports	Vienna Convention	Corrected tax expenditures	Sources
Burundi	2010	7.11	2.68	1.55	0.13	**5.43**	IFC/WB, 2012, Burundi: Summary Analysis and Proposals for Reforming the Regime for Investment Incentives.
Ghana	2011	6.13	1.07	0.25		**5.88**	OECD, 2013, Analysis of Tax Expenditure in Ghana, Février.
	2010	7.48	4.25	3.07	0.00	**4.41**	
Morocco	2011	3.9	1.61	0.07	0.00	**3.83**	Ministère de l'Economie et des Finances, 2012, Prapport sur les dépenses fiscales, Royaume du Maroc.
	2010	3.90	1.8	0.00		**3.90**	
Senegal (1)	2009	4.99	3.23	1.28	0.08	**3.63**	Ministère de l'Economie et des Finances, 2011, Rapport de l'étude sur les dépenses fiscales de l'année 2009, République du Sénégal.
Sierra Leone	2012	8.30		4.54	0.07	**3.69**	Losing out. Sierra Leone's massive revenue losses from tax incentives, Avril 2014.
	2011	13.70		11.85	0.19	**1.66**	

1: The Senegalese report of tax expenditures corrected from the illusion due to VAT by distinguishing VAT exemptions from VAT suspensions. The total of tax expenditures reduced by 77 billion FCFA and estimated at 223 billion FCFA (3.63 percent of GDP) instead of 300 billion FCFA.

2: The reported VAT exemptions on imports concern the formal sector, in particular the extractive industries.

Increasing the scope of evaluation: the illusion of an increase in benefits

No country, not even those countries most accustomed to reporting and to publishing reports about tax expenditure, actually performs an extensive evaluation of these expenditures. Only a complete and published inventory of tax expenditures can be exhaustive. A scope of evaluation is set using this inventory, which specifies which tax expenditures will be subjected to an assessment in a given year. In the countries initiating this process, the scope for the first year is obviously limited. The scope increases with time. Publishing the estimated total of tax expenditures during a given year can bring about misleading interpretations if it is used to make international comparisons, or which could bring about worse consequences in terms of tax policy, to estimate the changes in benefits granted in a country.

Today, SSA countries are particularly exposed to the risks of an abusive interpretation of the changes in the global amount of tax expenditure. They have recently been concerned with the assessment of tax expenditures, and the practice first started with a very limited scope because of the lack of available data and sometimes, the lack of means. As an example: VAT exemptions provided in the general tax code to support the prices of basic products cause a tax expenditure which is, as a general rule, not estimated during the first years. The data on a potential tax base do not exist and services have no means to reconstitute it. Customs would be able to quantify this tax expenditure on imported goods but do not do it: their computerized customs clearance system was set up with the premise that VAT exemptions in the general tax code are considered as statutory law for customs administrations. It is obvious, and some countries have experienced this first hand, that including this tax expenditure in the evaluation scope leads to a large increase in the total amount of tax expenditures.

Conclusion

The different illusions briefly described in this note are likely to seriously jeopardize the aim of budget transparency at the origin of tax expenditures assessment. This risk is greater when the assessment is published. However tax expenditures estimation has today become a necessary practice to effectively struggle with the proliferation of exemption schemes.

Introduced in the African continent in 2005 with the Moroccan experiment, tax expenditures assessment has generated a keen interest encouraged by donors. Some of the exercises carried out have often been the cause of illusions. One of the main reasons for this is certainly the haste with which countries have become involved in this process. They often did not take the time to bring into this exercise the necessary rigor, specifically when it comes to defining a benchmark tax system, the cornerstone of any tax expenditure assessment.

In order to limit as much as possible tax expenditures illusions, a standardization of their assessment is necessary. It would allow not only the marking out of the world's best practices (CIAT, 2011), but also raising awareness of the major errors, which can lead to a significant over- or under-estimation. Moreover, the assessment of tax expenditure, which represents a critical issue in relation to tax policy, should not be in the hands of tax collection departments, which are too involved and therefore likely to magnify the illusions, but in the hands of a transversal structure under the direct authority of the Minister of finance.

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Contact
www.ferdi.fr
contact@ferdi.fr
+33 (0)4 73 17 75 30

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