*Chapter 2*

# External financial flows and tax revenues for Africa

This chapter analyses recent trends in development financial flows from African countries' perspectives. It compares foreign direct investments, portfolio investments, remittances and official development assistance with the trends in tax revenues. It also describes the relative importance of each of these flows for various country income groupings. While different in nature, these flows constitute the main sources available for African countries to meet their financing needs. Using data starting from 2000, the chapter provides estimates for 2013 and projections for 2014.

## In brief

External financial flows and tax revenues play an increasingly important role in Africa's development and economic growth prospects. External financial flows have quadrupled since 2000 and are projected to reach over USD 200 billion in 2014. Their composition has also changed progressively with foreign investments and remittances from non-OECD countries underpinning this positive trend. Foreign investment – direct and portfolio – has now fully recovered from the 2009 economic crisis and is projected to reach over a record USD 80 billion in 2014, making it the largest financial flow to Africa. Though resource-rich countries remain the prime destination for foreign direct investment (FDI) to Africa, manufacturing and services attract an increasing share of the over 750 new greenfield FDI projects. Official remittances have been continuing their increasing trend since 2009 and are projected to reach USD 67.1 billion in 2014. In contrast, official development assistance's (ODA) share of total external flows keeps diminishing, from 38% in 2000 to 27% in 2014 (estimated at USD 55.2 billion). Despite this downward trend, ODA still represents the largest external financial flow to low-income African countries. Tax revenues continue to increase in Africa and reached USD 527.3 billion in 2012. They should not be seen as an alternative to foreign aid but as a component of government revenues that grows as countries develop.

## While external financial flows have been slow, they are expected to increase in the near future

This section provides an overview of the different external financial flows to Africa. The report covers foreign direct investments, portfolio investments, remittances and official development assistance. It looks at their relative importance for different country income groupings: low-income countries, lower-middle-income countries and higher-middle-income countries.

### The past increase in external financial flows to Africa has been slowed down by portfolio outflows in 2013

In 2013 total external flows[1] to Africa were estimated at USD 186 billion, about the same size recorded in 2012, and represented 8.9% of the continent's gross domestic product (GDP) (Figure 2.1 and Table 2.1). The sharp decrease in portfolio flows, a rather volatile source of investment for the continent over the last decade, explains this stagnation and offsets the slight recovery in FDI, remittances and ODA. Excluding South Africa, the largest recipient of investments on the continent, total external flows increased by a nominal 5% in 2013.

Private financial flows – investment and remittances – are increasingly contributing to Africa's development finance landscape. Their share of total external flows, which were 63% over 2000-05, are likely to rise to 71% over 2010-14. FDI, in particular, can be instrumental to develop productive capacities and remove infrastructure bottlenecks, especially energy and transport networks. Recorded remittances have been more resilient to the economic and financial crisis of past years and, as such, have emerged as a stable source of revenue for some 120 million people in Africa, supporting consumption, education and health expenses.

Non-OECD countries are more and more relevant in sustaining private financial flows to Africa. During 2012 and 2013 the increase in remittances from the Gulf Co-operation Council countries[2] and FDI from the BRICS countries[3] compensated the relative decline of private financial flows from OECD countries since the onset of the 2009 global economic crisis. FDI flows from non-OECD countries are also driving increasing investments in the manufacturing and services sectors.

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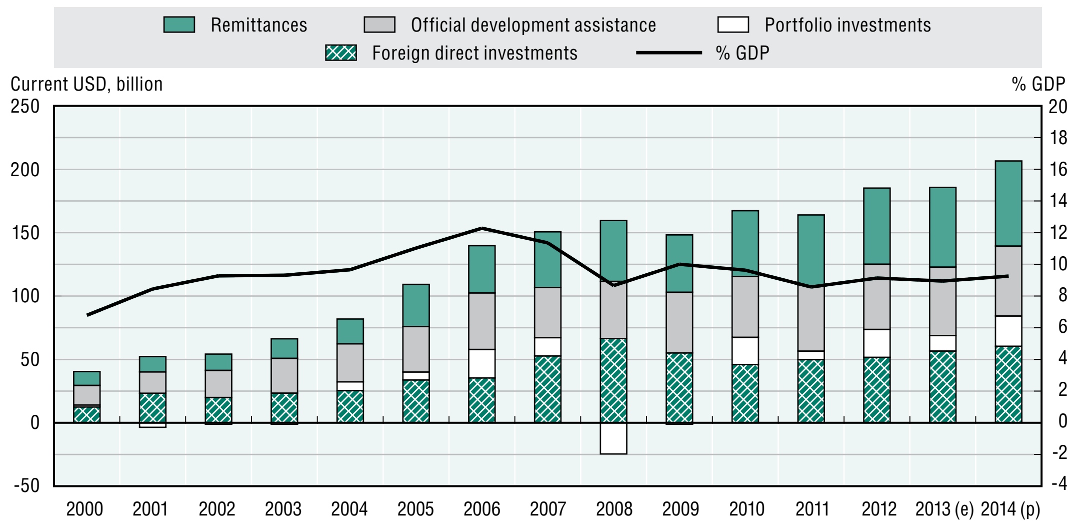
Figure 2.1. **External financial flows to Africa**




*Note*: ODA (e) estimates and (p) projections based on the real increase of Country Programmable Aid in the forthcoming *OECD Report on Aid Predictability: Survey on Donors' Forward Spending Plans 2013-2016*. Forecast for remittances based on the projected rate of growth according to the World Bank. (This figure excludes loans from commercial banks, official loans and trade credits.)

*Source*: Authors' calculations based on OECD/DAC, World Bank, IMF and *African Economic Outlook* data.

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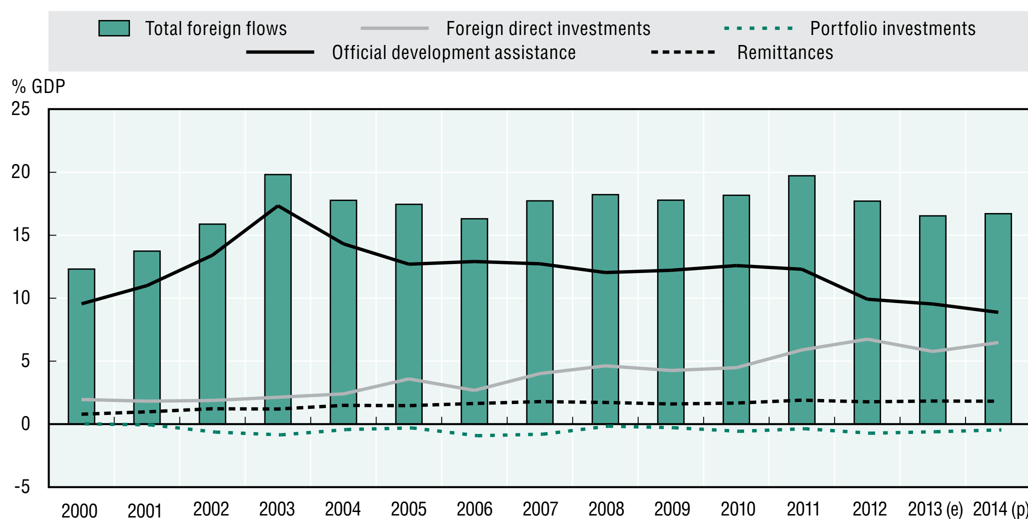
The aggregate numbers in Figure 2.1 mask different realities for countries at different levels of development (Figures 2.2, 2.3 and 2.4). For the 27 low-income African countries, accounting for half of the continent's one billion people, ODA still provides more than half the total external flows (Figure 2.2). At the same time, the ODA share of GDP for this group of countries has been gradually decreasing, from an average of 13.1% in 2000-05 to 9.5% in 2013 and is projected to be 8.9% in 2014. According to current aid projections from the latest Survey on Donors' Forward Spending Plans of the OECD Development Assistance Committee, low-income countries are likely to have to rely increasingly on domestic resources and other external flows to compensate for the projected stagnation of ODA flows from OECD countries to Africa.

Figure 2.2. **Development finance to low-income-countries in Africa**

(% GDP, weighted)




*Note*: ODA (e) estimates and (p) projections based on the real increase of Country Programmable Aid in the forthcoming *OECD Report on Aid Predictability: Survey on Donors' Forward Spending Plans 2013-2016*. Forecast for remittances based on the projected rate of growth according to the World Bank. (This figure excludes loans from commercial banks, official loans and trade credits.)

*Source*: Authors' calculations based on OECD/DAC, World Bank, IMF and *African Economic Outlook* data.

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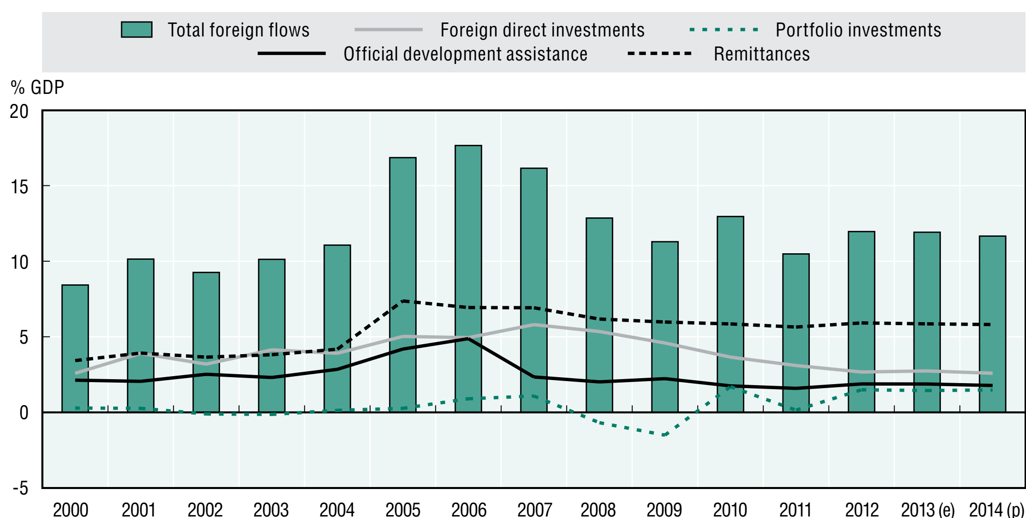
The story for lower-middle-income countries, representing an estimated 440 million people, is different, with remittances being the most important external flow over recent years (Figure 2.3). Recorded remittances increased to an estimated USD 52 billion in 2013, three times the value of ODA and twice the value of FDI going to these countries. This increase was mainly driven by remittances to Egypt and Nigeria. The true size of remittances is likely to be higher, since those transferred though informal channels are not recorded in this figure. Lower-middle-income countries have also been able to expand their access to international financial markets and attract portfolio investments. The latter are projected to represent on average 1.3% of GDP over 2010-14, compared to 0.1% in 2000-05.

Figure 2.3. **Development finance to lower-middle-income countries in Africa**

(% GDP, weighted)




*Note*: ODA (e) estimates and (p) projections based on the real increase of Country Programmable Aid in the forthcoming *OECD Report on Aid Predictability: Survey on Donors' Forward Spending Plans 2013-2016*. Forecast for remittances based on the projected rate of growth according to the World Bank. (This figure excludes loans from commercial banks, official loans and trade credits.)

*Source*: Authors' calculations based on OECD/DAC, World Bank, IMF and *African Economic Outlook* data.

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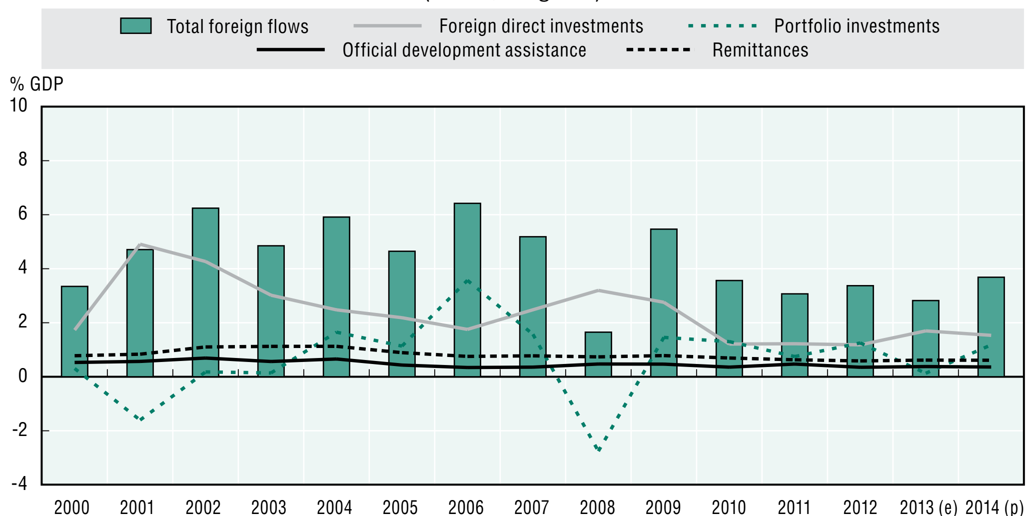
Figure 2.4. **Development finance to upper-middle-income countries in Africa**

(% GDP, weighted)




*Note*: ODA (e) estimates and (p) projections based on the real increase of Country Programmable Aid in the forthcoming *OECD Report on Aid Predictability: Survey on Donors' Forward Spending Plans 2013-2016*. Forecast for remittances based on the projected rate of growth according to the World Bank. (This figure excludes loans from commercial banks, official loans and trade credits.)

*Source*: Authors' calculations based on OECD/DAC, World Bank, IMF and African Economic Outlook data.

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For upper-middle-income countries, private investment represents the main source of development finance, accounting, on average, for 70% of total external flows over 2010-14 (Figure 2.4). Portfolio flows tend to increase in relative importance once a country reaches upper-middle-income status. They can help to strengthen financial infrastructure and liquidity but pose a challenge in terms of increased volatility.

### Total external flows to Africa are likely to reach a new record in 2014

Total external flows to Africa are projected to reach over USD 200 billion in 2014. This projection depends on the uncertain recovery of portfolio flows to South Africa in 2014. FDI and remittances are likely to maintain their upward trend and underpin the high level of external flows to Africa (Table 2.1). On the one hand, demand for commodities by emerging economies and the related high prices are likely to underpin further FDI flows to the natural resource sectors; on the other, the continent's projected strong economic growth and favourable demographics, with an expanding consumer base, are driving increasing investments towards the manufacturing and services sectors. Following current trends, ODA is projected to peak at around USD 55.2 billion in 2014 and then stagnate.

Table 2.1. **Financial flows and tax revenues to Africa**
(current USD, billion)

| | | | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013(e) | 2014(p) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Foreign | Private | Foreign direct investments | 33.8 | 35.4 | 52.8 | 66.4 | 55.1 | 46.0 | 49.8 | 51.7 | 56.6 | 60.4 |
| | | Portfolio investments | 6.3 | 22.5 | 14.4 | -24.6 | -0.3 | 21.5 | 6.8 | 22.0 | 12.2 | 23.9 |
| | | Remittances | 33.3 | 37.3 | 44.0 | 48.0 | 45.2 | 51.9 | 55.7 | 60.0 | 62.9 | 67.1 |
| | Public | Official development assistance (net total, all donors) | 35.8 | 44.6 | 39.5 | 45.2 | 47.9 | 48.0 | 51.8 | 51.4 | 54.1 | 55.2 |
| | | **Total foreign flows** | **109.2** | **139.7** | **150.6** | **135.0** | **147.9** | **167.3** | **164.1** | **185.1** | **185.7** | **206.5** |
| Domestic | | Tax revenues | 259.3 | 305.3 | 334.6 | 432.9 | 331.0 | 409.1 | 467.4 | 527.3 | … | … |
| **Total foreign flows** | | Low-income countries | 21.8 | 22.8 | 29.5 | 36.5 | 36.9 | 39.5 | 47.5 | 48.3 | 49.2 | 54.5 |
| | | Lower-midddle-income countries | 61.7 | 78.4 | 84.1 | 81.8 | 69.4 | 94.7 | 84.9 | 100.7 | 105.7 | 111.2 |
| | | Upper-middle-income countries | 23.2 | 35.6 | 33.2 | 11.9 | 35.9 | 28.1 | 26.5 | 30.8 | 25.1 | 35.0 |

Note: ODA (e) estimates and (p) projections based on the real increase of Country Programmable Aid in the forthcoming *OECD Report on Aid Predictability: Survey on Donors' Forward Spending Plans 2013-2016*. Forecast for remittances based on the projected rate of growth according to the World Bank. (This table excludes loans from commercial banks, official loans and trade credits.)
*Source*: Authors' calculations based on OECD/DAC, World Bank, IMF and *African Economic Outlook* data.

External downside risks to this outlook emanate from the possible deterioration in global economic activity in 2014. This would likely weaken commodity exports and result in a slowing down or reduction of investment projects. In addition, it might further reduce projected ODA and remittance flows. African countries that are more financially integrated into global markets are exposed to a potential protracted reversal of capital flows in case of further monetary tightening in the OECD area, which would mostly affect portfolio flows. Regional risks to this outlook are related to lingering unrest and instability in the Sahel region, Northern Nigeria, Central African Republic and South Sudan, which could weigh on investor sentiment in neighbouring countries (IMF, 2013a).

## Foreign investment is increasingly important to Africa's development

This section looks at the two components of foreign investment: FDI and portfolio investment. The OECD defines FDI as "a category of cross-border investment made by a resident in one economy with the objective of establishing a lasting interest in an enterprise that is resident in an economy other than that of the direct investor. The motivation to significantly influence or control an enterprise is the underlying factor that differentiates direct investment from cross-border portfolio investments. Portfolio investors do not have as an objective any long-term relationship. Return on the assets is the main determinant for the purchase or sale of their securities" (OECD, 2008).

## Foreign direct investment from emerging economies continues to increase in Africa

This sub-section looks at both major African FDI recipients as well as the sources of FDI. In addition it discusses outward African investment and provides an outlook for FDI to Africa in 2014.

FDI to Africa was more resilient than around the globe. The persisting global economic instability and policy uncertainty dampened the recovery of global FDI flows throughout 2012 and 2013. Against this backdrop, FDI to Africa increased in both 2012 (+5%) and 2013 (+9.6%). It reached an estimated USD 56.6 billion in 2013, up from USD 51.7 billion in 2012 (IMF, 2013b). Developed economies suffered the largest contraction, while developing countries as a whole recorded a smaller decline (-3% in 2012). The outlook for 2014 and 2015 is more positive: investor confidence is likely to pick up and underpin a recovery in global FDI to a projected USD 1.6 trillion and USD 1.8 trillion respectively. Yet these amounts remain below the 2007 peak of USD 2 trillion (UNCTAD, 2014).

FDI has emerged as an especially important source of investment for the continent. Over the period 2001-11, FDI accounted on average for about 16% of gross fixed capital formation, compared to the global average of 11%. However, Africa's share of global FDI has slightly declined – down to 3.7% in 2012, compared to the 2009 peak of 4.3% – as the pickup in flows to other developing regions has been stronger. This decline notwithstanding, Africa's positioning in the global FDI landscape is much better today than at the beginning of the century, when its share stood about 0.6% (UNCTAD, 2013).

### Recipients of foreign direct investment

The buoyant demand for oil, minerals and other natural resources over recent years has driven investment flows to Africa. Not surprisingly, large resource-rich countries have been the biggest beneficiaries. In 2013, resource-rich countries accounted for 95% of the increase in FDI to Africa, driven by both a surge of USD 1.8 billion (+39%) in inflows to South Africa and a reduction of USD 1.7 billion (-61%) in disinvestments from Angola. Three countries – Algeria, Namibia and Nigeria – recorded an increase in FDI flows of over USD 0.5 billion each (IMF, 2013b).

At the same time, the share of total FDI to resource-rich countries is now gradually decreasing: they received an estimated 65% of total FDI flows in 2013, compared to 78% in 2008 (Figure 2.5). The change reflects the emergence of other investment drivers but also the fact that some planned investment in the extractive sector has been put on hold. The slowdown of the global economy at the onset of the 2009 economic crisis has led to lower demand for Africa's commodity exports, which delayed planned FDI in extractives.

For their part, non-resource-rich countries have seen a strong increase in the share of FDI inflows in their GDP since the early 2000s. In 2013, the groups' FDI-to-GDP ratio stood at 4.5%, twice the level in 2000. In comparison, the ratio for resource-rich countries stood at 2.2% in 2013 (IMF, 2013b).


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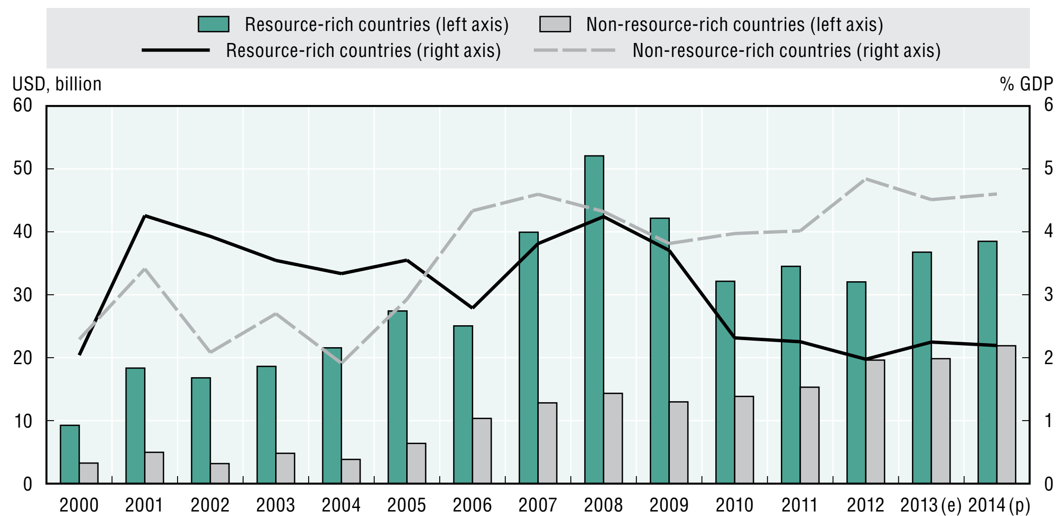
Figure 2.5. **Foreign direct investments to Africa: Resource-rich vs non-resource-rich**




*Source*: Authors' calculations based on IMF World Economic Outlook 2013. (e) estimates and (p) projections.
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FDI inflows to Africa are concentrated in a small number of countries. In 2013, the top six recipients, representing one third of the continent's population, received the same amount of foreign direct investment as the remaining 48 countries together. The largest recipients were South Africa and Nigeria, with respectively an estimated USD 6.4 billion and USD 6.3 billion. Mozambique (USD 4.7 billion), Morocco (USD 4.3 billion), Ghana (USD 3.3 billion) and Sudan (USD 2.9 billion) close the list. Those six countries were also the largest recipients in 2012. Egypt, traditionally one of top three recipients, has yet to recover to its pre-Arab Spring level: FDI averaged USD 9.1 billion per year over 2005-10 but was only USD 1.9 billion per year over 2011-13. Together with remittances and the Suez Canal receipts, FDI is a major source of foreign exchange to Egypt. The largest decrease in inflows for 2013 compared to 2012 were observed in Niger (USD -0.8 billion), Egypt (USD -0.7 billion) and Sierra Leone (USD -0.6 billion) (IMF, 2013b).

### Sources of foreign direct investment

In 2012, FDI from OECD countries to Africa declined for the second consecutive year. With USD 15.7 billion it stood at less than half its peak value of USD 34 billion in 2008 just before the global financial crisis. The four largest investors from OECD countries in 2012 were the United Kingdom (USD 7.4 billion), the United States (USD 3.7 billion), Italy (USD 3.6 billion) and France (USD 2.0 billion). Together the United States, the United Kingdom and France held 64% of total FDI stock in Africa in 2012, respectively USD 61.4 billion, USD 58.9 billion and USD 57.9 billion (OECD, 2014a).

As explored in detail in the *African Economic Outlook 2011*, emerging economies are becoming increasingly important investment sources for African countries. The share of the BRICS in Africa's total FDI stock rose from 8% in 2009 to 12% in 2012, amounting to USD 67.7 billion. While this figure confirms the decreasing relative importance of OECD countries as sources of direct investment, it is worth noting that Africa is losing momentum to other developing countries in terms of attracting FDI from the BRICS. The continent represents 5% of the BRICS' FDI stock in the world in 2012, compared to 5.6% in 2011 (IMF, 2014b).

Excluding OECD countries, China held the largest stock of FDI in Africa, estimated at USD 27.7 billion, followed by South Africa and Malaysia with respectively USD 22.9 and

USD 15.8 billion. The latest data from the IMF's Coordinated Direct Investment Survey indicate a decline of China's FDI stock in reporting African economies by USD 3.3 billion with respect to 2011, but the equivalent increase in the four other BRICS compensated for this (IMF, 2014b). Investment from the BRICS in greenfield projects represented almost one quarter of total new greenfield projects in 2012 (fDi Markets, 2013).

The value of greenfield investments in Africa declined in 2012, in line with the global decline in FDI. Yet the continent slightly increased its share of the global amount of new greenfield projects from 5.4% in 2011to 5.6% in 2012. So while there were more projects, their average value was smaller. This evidence is in line with the gradually increasing sectoral diversification of greenfield investments to Africa out of mainly the primary sector. Greenfield projects in manufacturing and services are typically smaller in value than the large capital-intensive investments in extractive industries (fDi Markets, 2013).

Foreign direct investments to Africa have become more diversified among sectors. The Herfindahl index for sectoral concentration of FDI for 39 sectors went down from 0.43 in 2003 to 0.14 in 2012. The relative share of projects in sectors such as financial services, business services and communications has grown considerably. In 2012 73.5% of the total value of greenfield investments to the continent went to manufacturing and infrastructure-related activities, up from 68.3% over the past decade (Ernst & Young, 2013a). Foreign direct investments in manufacturing and services have a larger job creation potential than investment in extractive industries.

As evidenced by the large inflows to resource-rich countries, natural resource endowments remain a major determinant of African countries' capacity to attract FDI. Yet new determinants are gradually becoming equally important. Particularly, the emergence of a larger middle class and higher purchasing power are driving a change in consumer behaviour and luring investors that are eager to expand into new markets. Over the past decade, the number of middle-class consumers in Africa has increased to 34% of Africa's population or nearly 350 million (AfDB, 2011). In addition, Africa's projected sustained economic growth and the high price of natural resources are likely to keep underpinning this growth in FDI to the continent. Stable macroeconomic policies and demographic trends are also likely to positively impact investment inflows. Africa's population is predicted to double by 2050 and become increasingly urbanised with the share of urban population likely to increase from 40% in 2011 to 54% in 2050 (UN DESA, 2013).

**Outward foreign direct investment**

Africa's outward investment tripled from USD 5.4 billion in 2011 to 14.3 billion in 2012, bringing the continent's share in global FDI outflows to a record 1%. This increase contrasts with decreasing global FDI outflows, which fell from USD 1 678 billion in 2011 to USD 1 390 billion in 2012.

In 2012, five countries represented over 85% of total African outward FDI: South Africa (USD 4.4 billion), Angola (USD 2.7 billion), Libya (USD 2.5 billion), Nigeria (USD 1.5 billion) and Liberia (USD 1.4 billion). South African investment was mainly directed to mining, the wholesale sector and health-care products. Since the onset of the global economic crisis, 2012 was the first year that South Africa was again Africa's leading investor abroad (UNCTAD, 2013).

With regards to sectors, intra-African investments are more diverse than investments from OECD countries. They have been increasing and are directed towards less capital-intensive and technology-intensive investments. African investors represented 18% of total greenfield projects to Africa in 2012, compared to 7% in 2007. Over the period

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2003-12 the amount of inter-African greenfield projects increased by 20% annually. The sectors that had the largest share of African investment over that same period were financial services (28%), building and construction material (28%), communications (22%), electronic components (18%), chemicals (18%) and consumer products (18%). The top five African investors in Africa over the period 2003-12 were South Africa, Mauritius, Egypt, Nigeria and Kenya, in that order (fDi Markets, 2013).

**Outlook for foreign direct investment**

The IMF projects FDI to Africa to further increase from USD 56.6 billion to USD 60.4 billion in 2014. Top recipients are likely to remain Nigeria (USD 6.5 billion), Morocco (USD 4.8 billion), South Africa (USD 4.8 billion) and Mozambique (USD 4.1 billion). North Africa is expected to continue its gradual recovery. As such, it should become the second largest recipient region of FDI after West Africa. Driven by the recovery of inflows to Côte d'Ivoire, large investments in Guinea's extractives and sustained investment in Ghana and Nigeria, West Africa is projected to be the largest recipient region in 2014, topping USD 16.6 billion. Southern Africa follows in third place, with a total of USD 12.2 billion, due to lower expected inflows to South Africa.

Downside risks to this outlook include both domestic uncertainties and the speed and shape of the global economic recovery. Lingering tensions and political instability in some of the major FDI recipients, such as Egypt, Mozambique, Nigeria and Sudan, could affect investors' willingness to undertake planned projects. A potential exacerbation of the unrest in the Sahel region might also wear down investor sentiment in neighbouring countries. These ongoing political risks complicate bridging the perception gap that remains a barrier to foreign investment to Africa, in particular from investors that do not yet have a presence on the continent (Ernst & Young, 2013b). External risks emanate mainly from a lagged economic recovery in the euro area, the impact of potential changes in the US monetary policy and a possible slow-down in emerging economies (IMF, 2013a).

Box 2.1. **Policy findings of the NEPAD-OECD Africa Investment Initiative at national and regional levels**

At national level, the findings below concern Mauritius, Nigeria and Tanzania:

- Small market size and geographical isolation combined with high labour costs and biased investment incentives towards traditional sectors systemically constrain **Mauritius'** investment policy. In addition, the government promotes economic sectors unsuited to the country's skill base. Domestic businesses are reluctant to diversify away from established sectors such as sugar, tourism, financial services and real estate. The review recommends *i)* clarifying the legal framework for investment and ensuring that efforts to attract investment are effective and sustainable; *ii)* improving supply-side enablers for investment (including human resources and trade); *iii)* making more room for private investment in infrastructure markets.
- The 2013 review of **Nigeria's** investment policy at the federal level recommends better securing contractual and property rights and striking a better balance between investors' rights and obligations. There is a need to prioritise key economic sectors for trade and investment in combination with a more open trade policy. The federal competition bill and the national code of corporate governance need to be enacted. At Lagos State level, the review encouraged focusing on modernising the legal framework for land titling and limiting the functions of the Investment Promotion Unit's work. It recommended designing a plan for small- and medium-sized enterprises and helping them recover costs of public-private partnerships for infrastructure.

Box 2.1. **Policy findings of the NEPAD-OECD Africa Investment Initiative at national and regional levels** (cont.)

- The **Tanzania** Investment Policy Review highlights the following priorities for improving FDI attractiveness: *i*) rationalise investment incentives; *ii*) strengthen domestic suppliers; *iii*) make small- and medium-sized enterprises more competitive through better access to finance; *iv*) increase land tenure security for investors; *v*) facilitate access to private investment in infrastructure.

At the regional level, the joint project between the NEPAD-OECD Africa Investment Initiative and the 14 member states of the Southern African Development Community (SADC) addresses four policy areas that present specific risks and bottlenecks for further expansion of domestic and foreign investment: *i*) investor protection; *ii*) FDI restrictions; *iii*) a level playing field for private investment in infrastructure; *iv*) tax incentives for investment. The objective is to avoid a detrimental "race-to-the-bottom" among neighbouring countries in these areas by providing a benchmark against which member states can plan and assess progress in improving their investment policy. Endorsement of the completed framework by the SADC Ministers of Investment and Finance is targeted for end 2015.

*Source*: NEPAD-OECD Africa Investment Initiative, www.oecd.org/investment/investmentfordevelopment/africa.htm.

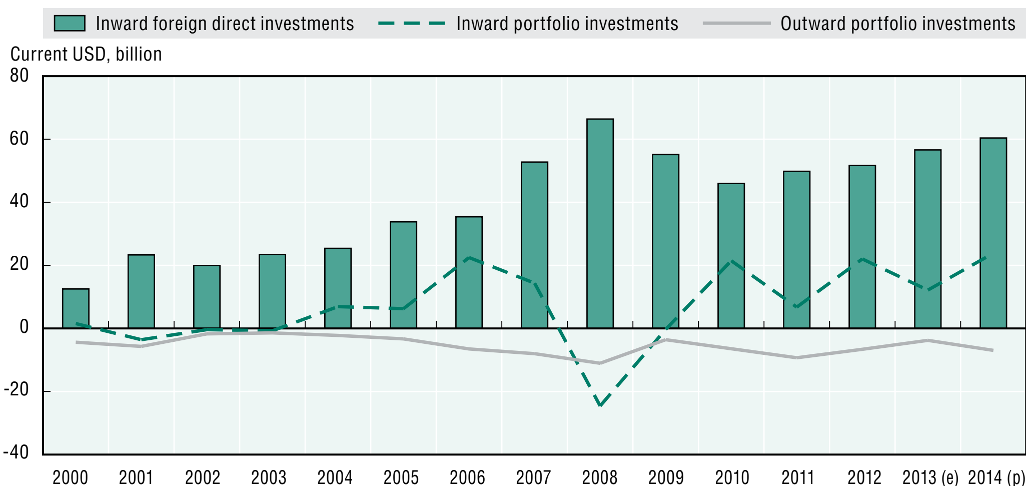
## Portfolio investments to Africa remain volatile

The following sub-sections describe both the decrease in inward as well as outward portfolio investments in 2013. Portfolio investments include international investments in both equity and debt securities issued by non-resident entities.

### Portfolio inflows

Portfolio investments have been taking up a gradually growing share of total investments to Africa over the past decade, but they have also shown much greater volatility than other sources of external financing (Figure 2.6). In 2013, for example, portfolio investments nearly halved to an estimated USD 12.2 billion. The outlook for portfolio flows will to a large extent depend on the impact of higher interest rates in OECD economies. Hence, the projections by the International Monetary Fund (IMF) for portfolio flows to the continent in 2014 are likely to be on the upper bound.

Figure 2.6. **Foreign direct investments and portfolio investments to Africa**




*Source*: Authors' calculations based on IMF World Economic Outlook 2013. (e) estimates and (p) projections.
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The sudden drop in portfolio investments in 2013 is largely due to South Africa's near USD 10 billion decrease to an estimated USD 1.5 billion in 2013. Nigeria, though also having recorded a drop of USD 3.3 billion in inflows, is Africa's largest recipient of portfolio investments. Ghana also recorded a large decline, down to USD 0.48 billion from a record USD 1.1 billion in 2012. The Democratic Republic of the Congo, Côte d'Ivoire, Egypt, Libya, Mauritius and Mozambique recorded negative portfolio inflows.

Portfolio investment stocks[4] in Africa were estimated at USD 200 billion in 2012. This figure is roughly five times its value a decade earlier and reflects the greater development of African debt and equity markets and the willingness of foreign investors to take risks on those markets (ODI, 2013). South Africa alone represented 70% of total portfolio stock. In recent years, Mauritius has consolidated its position as a major recipient of portfolio investment to Africa, with USD 15 billion in portfolio investment stock, second to South Africa. In 2011 the United States held the largest stock of African portfolio investment, worth USD 86 billion and representing 43% of the total stock (IMF, 2014a).[5]

In comparison to FDI flows which have been steadily increasing for the past three years, portfolio investments have shown persistent volatility since their first surge to USD 22.5 billion in 2006. For African countries that are gaining increasing exposure to portfolio flows, this volatility can create an unstable investment environment detrimental to growth and development through its negative impact on consumption and the availability of finance. It may also trigger compensatory adjustments in monetary, fiscal and exchange rate policies in the face of rapid changes in the availability of external finance (UNCTAD, 1999).

While Africa's stock markets remain thin and illiquid, some regions have undertaken steps to promote stock market regionalisation. The Anglophone countries are planning to form a regional stock exchange under the umbrella of the Economic Community of West African States. Kenya, Tanzania and Uganda aim to create a regional stock exchange in East Africa. The Southern African Development Community has also proposed to form a regional stock exchange (Senbet and Otchere, 2008).

Tighter monetary policies in the United States might lead to lower investment and growth in Africa through its negative impact on the cost of capital. African countries that are more financially integrated into the global economy are more exposed to interest rate hikes in developed countries. These include economies such as Kenya, Nigeria and South Africa that have seen strong portfolio inflows and that risk sudden stops of capital inflows. Countries that plan to tap into international bond markets may have to face higher coupon rates (World Bank, 2014a).

**Portfolio outflows**

Portfolio outflows from Africa, including international equity and debt investments by residents, decreased for the second consecutive year: from USD 6.6 billion in 2012 to an estimated USD 3.8 billion in 2013. With USD 2.6 billion, South Africa represented nearly 70% of total portfolio outflows, followed by Angola with USD 0.9 billion. Namibia, Egypt, Botswana, Kenya, Sierra Leone and Gambia all recorded minor portfolio investment outflows (IMF, 2014a).

African sovereign bond issuances have soared in 2013. They rose close to a record USD 10 billion, compared to only USD 1 billion a decade ago. The Seychelles and Ghana were the first two sub-Saharan African countries that issued sovereign bonds, in 2006 and 2007 respectively. Gabon, Nigeria, Senegal, Namibia, Zambia and Rwanda have followed suit, in that order. Underpinned by loose monetary policies in Europe, the US and Japanese investors looked for higher yields in African sovereign bond markets.

More and more African countries are likely to develop their sovereign bond markets to attract additional financing. Despite these recent issuances, Africa's sovereign bond market remains small, but likely future first-time issuances from Angola, Cameroon, Kenya, Mozambique, Tanzania and Uganda should offer investors increasing opportunities to diversify risks (Moody's, 2013). International bond markets provide an avenue for African countries seeking financing when domestic resources and ODA are inadequate to meet their substantial needs of economic and social infrastructure (AfDB, 2013).

## Remittances are the largest single external flow to Africa

This section describes the recent trends in officially recorded remittances to Africa. It looks at the main recipients and emitting countries. The data and estimates do not include the unrecorded flows through formal and informal channels, which explain why the true size of total remittances to Africa is considered to be significantly larger.

### Remittances to Africa are an important source of revenue for supporting consumption, education and health expenses

Official remittances to Africa increased for the fourth consecutive year, though at a decreasing rate. They were estimated at USD 62.9 billion in 2013 compared to USD 60.0 billion in 2012. This represents a nominal growth rate of 4.8%, compared to 7.7% in 2012 and 14.8% in 2010. Africa receives 11.5% of global remittance flows, slightly above its average share of 11.3% over the past five years. At country level the largest nominal increases were noted by Sudan (+155%), Uganda (+34%), Burkina Faso (+17%) and Niger (+13%) (World Bank, 2013a).[6]

Overall, official remittances per capita have increased steadily over the past decade in Africa. In 2013 they were estimated at 58 USD per person, compared to only 18 USD per person ten years earlier.

Table 2.2. **Fifteen largest recipient countries to Africa in 2013**

| Country | USD per capita | % GDP | Current USD, billion |
|---|---|---|---|
| Cabo Verde | 374.5 | 8.9 | 0.17 |
| Lesotho | 369.7 | 26.3 | 0.65 |
| Seychelles | 311.4 | 2.1 | 0.03 |
| Egypt | 254.7 | 7.6 | 20.00 |
| Tunisia | 227.9 | 4.8 | 2.31 |
| Morocco | 218.8 | 6.3 | 6.64 |
| Nigeria | 132.0 | 7.2 | 21.00 |
| Senegal | 123.5 | 10.2 | 1.56 |
| Liberia | 104.4 | 20.2 | 0.40 |
| Gambia | 83.8 | 16.5 | 0.15 |
| Togo | 62.4 | 8.7 | 0.37 |
| Swaziland | 57.8 | 1.5 | 0.06 |
| Algeria | 56.1 | 0.9 | 1.98 |
| Djibouti | 40.3 | 2.4 | 0.03 |
| Sâo Tomé and Príncipe | 36.9 | 2.1 | 0.01 |

*Source:* Authors' calculations based on World Bank data.

A more granular analysis reveals that the increase in official remittances is largely benefiting lower-middle-income countries. They received USD 118 per person, compared to USD 11 for low-income countries and USD 40 for higher-middle-income countries. Such disparities may reflect different profiles of migrants from low- and middle-income countries. Education level is a key determinant to emigration; because the average level of education is higher in middle-income countries, the emigration rate is higher than

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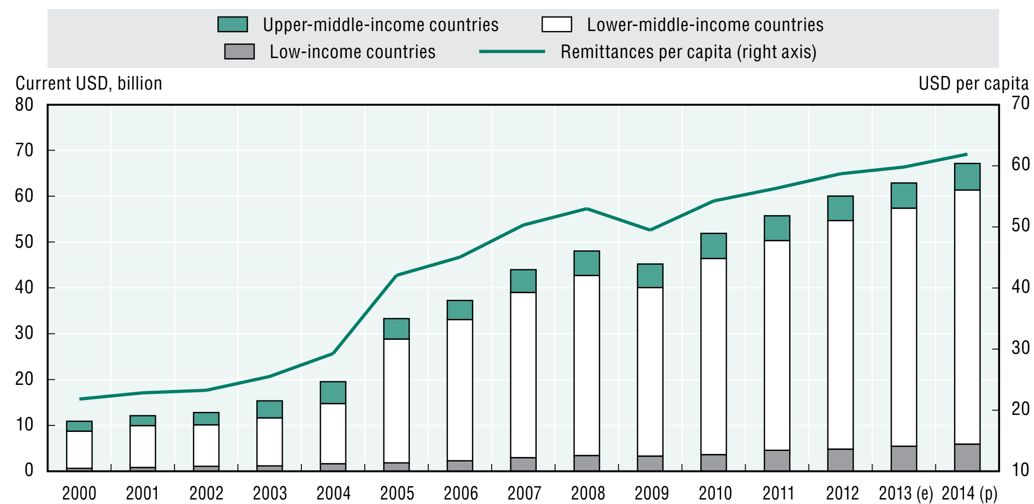
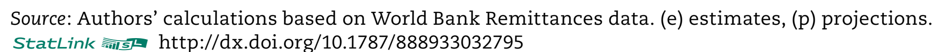
in low-income countries (Martin and Taylor, 1996). Cabo Verde, Lesotho and Seychelles each recorded over USD 300 of remittances per person (Table 2.2). Their large diaspora, geographic location and small population size explain these high figures.

The importance of remittances as an external private source of finance differs strongly among African countries (Figure 2.7). In 2013 North Africa perceived close to half of all remittances to Africa. This represented 4.4% of its GDP, compared to 3.3% in 2009. The region's proximity to Europe explains this high share. For countries like Gambia, Lesotho, Liberia and Senegal, remittances represent a significant share of their GDP.

Figure 2.7. **Remittance flows to Africa, 2000-14**




*Source*: Authors' calculations based on World Bank Remittances data. (e) estimates, (p) projections.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## OECD countries are sending fewer remittances to Africa while non-OECD countries are sending more

The share of recorded remittances from OECD countries in 2012 equalled 55%, down from 60% in 2010. Migrant workers based in France, the United Kingdom and the United States account for half of total remittances to Africa from OECD countries. In 2012 over 70% of the recorded remittances to Nigeria came from migrant workers in the United Kingdom and the United States. Morocco (USD 1.9 billion), Algeria (USD 1.4 billion) and Tunisia (USD 1.0 billion) represented over 83% of total remittances from migrants based in France (World Bank, 2014b).

Middle Eastern countries drove the strong increase in remittances over recent years. They represented 26% of total remittances to Africa in 2012, compared to 20% in 2010. Saudi Arabia was the largest Middle Eastern emitter and the second largest emitter overall (Table 2.3). Close to 90% of its remittances went to Egypt, reflecting the large outflows of migrants following the Arab Spring in 2011. In 2012 countries from the Gulf Co-operation Council represented 50% of total remittances to Egypt, amounting to nearly USD 10 billion. These remittances are sent by the 2.4 million Egyptian migrants in the Gulf Co-operation Council countries, including 1.3 million in Saudi Arabia alone (UN Population Division, 2013).

Table 2.3. **Fifteen largest emitting countries to Africa**
(current USD, billion)

| Emitting country | 2012 | 2010 |
|---|---|---|
| United States | 8.4 | 7.5 |
| Saudi Arabia | 6.5 | 4.3 |
| France | 5.3 | 5.2 |
| United Kingdom | 5.2 | 4.8 |
| Jordan | 3.8 | 2.4 |
| Italy | 3.7 | 3.4 |
| Spain | 3.0 | 2.9 |
| Libya | 2.3 | 1.3 |
| Kuwait | 2.2 | 1.4 |
| Chad | 1.4 | 1.4 |
| Germany | 1.4 | 1.2 |
| Canada | 1.3 | 1.1 |
| United Arab Emirates | 1 | 0.1 |
| Cameroon | 1 | 0.9 |

*Source*: World Bank bilateral remittance matrix 2012.

In comparison, African countries emitted on average 20% of total official remittances to Africa in 2012. However, taking into account informal remittances, about 67% of incoming flows to Africa come from migrants living in other African countries (World Bank, 2013a). Cameroon, Chad and Libya were the three largest African countries sending official remittances in 2010-12. Cameroon and Chad both sent over 95% of their remittances to Nigeria during 2010-12. Libya sent over 85% of its remittances to Egypt over the same period. According to the UN DESA migration data, Côte d'Ivoire is the leading destination for African emigrants, followed by South Africa, the United States and the United Kingdom.

The average cost of sending remittances to sub-Saharan Africa is among the highest around the world. It is over 12%, compared to a global average total cost for sending remittances of 8.9% (World Bank, 2013c). The ten most expensive corridors globally were all intra-African, with the top five originating from South Africa at rates as high as 25% (World Bank, 2013d). Lowering the taxes on remittance outflows from sending countries could increase the amount of remittances reaching their destination. Also, increasing competition between money transfer operators in Africa could lower the cost of sending remittances. Both measures could improve the development impact of remittances.

### Official remittances are likely to continue increasing in the near future, albeit at a slower pace

The World Bank expects official remittance flows to continue to increase for all regions of the world, including to Africa. For 2014 the Bank projects a total level of remittance flows to Africa of USD 67.1 billion, representing a growth rate of 8.6% for official remittances to sub-Saharan Africa and 4.9% to North Africa.

The circumstances facing migrants in their host countries can affect this outlook. In particular remittances coming from European economies, which represent a third of total remittances to Africa, may feel the impact of a potential lagged recovery in Europe. For instance, Spain and Italy have seen their migrant unemployment rates increase further. In 2012, 34.7% of Spain's migrant workers were unemployed, compared to only 10.3% in 2007 (OECD, 2013). In Italy the figure was 13.9% in 2012, compared to 11.7% in 2011. Both countries provided roughly a quarter of total remittances from EU migrants to Africa. Their remittances went largely to Egypt, Morocco, Nigeria, Senegal and Tunisia.

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## Official development assistance to Africa remains resilient

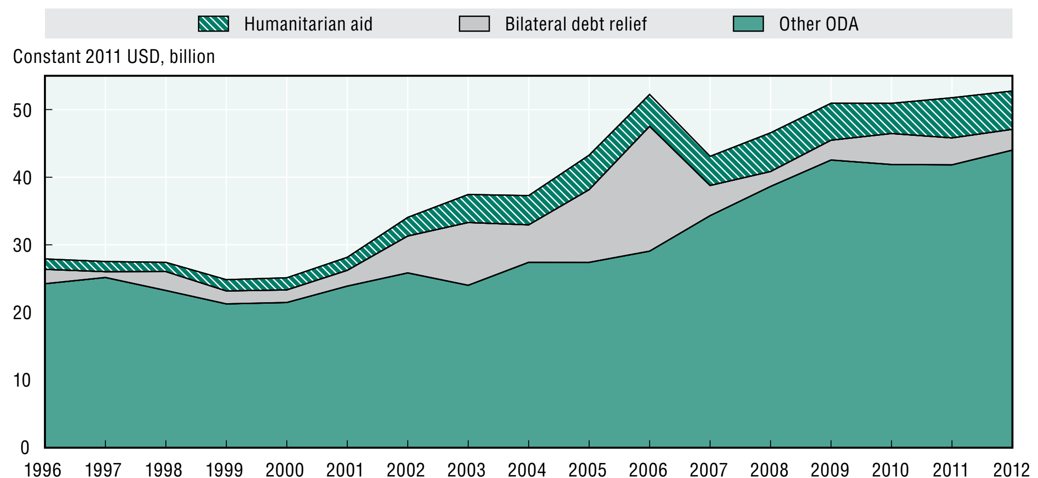
This section takes stock of the latest figures from the OECD Development Assistance Committee (DAC) on official development assistance for 2012 and examines Country Programmable Aid to identify trends for the period 2013-16. Country Programmable Aid (CPA) is a sub-set of gross bilateral official development assistance that measures actual transfers to partner countries. CPA is critical for delivering international aid commitments in support of the Millennium Development Goals but also represents the proportion of aid that is subjected to country allocation decisions by the donor.

### The global decline in official development assistance did not affect Africa in 2012

Total official development assistance to developing countries declined in 2012 for the first time in five years. In 2012 it stood at USD 136.4 billion, back at the level of 2009. This represents a decrease of 3.3% in real terms[7] compared to USD 141.1 billion in 2011. The drop in global ODA is largely due to a 6.5% decline in real terms of bilateral ODA from USD 102.2 billion in 2011 to USD 95.5 billion in 2012. This decrease in bilateral flows is also reflected in the share of ODA to gross national income (GNI) from OECD/DAC countries, which declined from 0.31% in 2011 to 0.29% in 2012. ODA from multilateral organisations, however, increased for the third consecutive year to a record USD 40.9 billion (OECD, 2014b).

In contrast to the overall drop in official development assistance, in 2012 Africa recorded a real growth of net ODA inflows for the second consecutive year (Figure 2.8). Net ODA disbursements increased by 1.9% to USD 52.7 billion, compared to USD 51.7 billion in 2011. Both non-DAC donors and multilateral aid accounted for this slight increase and compensated for the 4.9% decrease in real terms of ODA to Africa from DAC countries.

Figure 2.8. **Net official development assistance disbursements to Africa**




*Source*: OECD (2014b).

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OECD/DAC countries remain the largest contributors of official development assistance to Africa. Over the period 2007-12 they represented an average 61% of total ODA, compared to 37.6% for multilateral institutions and 1.5% for non-DAC countries. In 2012 Turkey nearly tripled its ODA to Africa to USD 749 million and accounted for 65% of the total contribution of non-DAC countries. From the multilateral donors the World Bank's International Development Association accounted for 23.8% (USD 4.7 billion)

of total multilateral ODA to Africa. The two other main multilateral donors are the Global Fund to Fight AIDS, Tuberculosis and Malaria (USD 2.2 billion) and the African Development Bank's African Development Fund (USD 1.8 billion).

The largest donors have maintained their relative share of ODA contributions to Africa over the past five years. In 2012, the United States, the United Kingdom and France provide the largest absolute amounts of bilateral ODA to Africa with respectively USD 9.1 billion, USD 4.1 billion and USD 3.4 billion. Their share of total ODA from DAC countries increased from 45% in 2007 to 55% in 2012. Canada and Germany had the largest increase of ODA to Africa by USD 311.5 million and USD 208.3 million respectively. Out of the 27 DAC donors, 19 recorded lower ODA flows to Africa. Italy and Spain recorded the largest decline in ODA by USD 718 million and USD 436.2 million respectively. In real terms this represents a decrease of 85.5% for Italy and 55.9% for Spain. France recorded a decline of USD 512.9 million, representing a decrease of 5.2% in real terms.

### Country Programmable Aid[8] to Africa is projected to stagnate from 2015 onwards

In 2013 the CPA volume to Africa is estimated to have bounced back to USD 42.4 billion compared to the previous level of USD 40.3 billion in 2012. This rise is due to increased funding going to North Africa and some large recipients. The biggest increases in Country Programmable Aid are planned for Nigeria (+USD 582.7 million), Mali (+USD 357.6 million), Kenya (+USD 323.8 million) and South Africa (+USD 322.7 million). Whereas the biggest decreases are planned in Senegal (-USD 234.3 million), Zimbabwe (-USD 199.8 million) and Ghana (-USD 114.1 million).

After peaking at USD 43.2 billion for 2014, the Survey on Donors' Forward Spending Plans indicates a slight decrease in 2015 and 2016 to USD 42.3 billion and USD 42.0 billion respectively. For 2014 the largest absolute increases are for Ethiopia with USD 152.3 million (+5%), Morocco with USD 112.4 million (+7%) and Senegal with USD 101.5 million (+13%). The largest decreases are expected in Egypt with USD 163 million (-8%), followed by Tunisia with USD 72.2 million (-9%) and Tanzania with USD 55.6 million (-2%). Country Programmable Aid is expected to decrease in both 2013 and 2014 for Cameroon, Cabo Verde, Djibouti, Libya, Malawi, Mauritania, Sao Tome and Principe, Tunisia, and Zimbabwe.

Low-income countries received the largest share of total Country Programmable Aid to Africa with 57.8%, compared to 33.2% for lower-middle-income countries and 9.0% for upper-middle-income countries. This distribution of CPA across country groupings is unlikely to change over the period 2013-16. As a share of GNI this represented an estimated 8.7% for low-income countries, 4.3% for lower-middle-income countries and 0.9% for upper-middle-income countries. By 2016 the Survey on Donors' Forward Spending Plans estimates, these shares are likely to further decrease to 7.4% for low-income countries and 3.0% for lower-middle-income countries and while remaining the same for upper-middle-income countries.

However, relative to population size, low-income countries received the lowest Country Programmable Aid per capita with an average 48.5 USD. In comparison, lower-middle-income countries obtained the largest CPA per capita with USD 89, while upper-middle-income countries received USD 66.1 per capita. Low-income countries represent an estimated 510 million people, close to half of Africa's population. These countries rely most on foreign aid flows to provide basic public services to their population yet receive a relatively smaller amount of CPA according to their needs. CPA is projected to decrease from its peak of 39.6 USD per capita in 2013 to 36.5 USD per capita in 2016, reflecting Africa's growing population in contrast to the stagnation in CPA.

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On the donor side the current fiscal crunch in Europe has led some countries to revise downwards their commitments and targets. Particularly Greece, Italy, Portugal and Spain – the countries most affected by the euro area crisis – have recorded the largest cuts. As a result the EU-28 official development assistance is expected to increase to only 0.43% of GNI by 2015 (EU, 2013). This remains below the level reached in 2010 and close to 40% below the 0.7% target. For reference, reaching this 0.7% ODA/GNI target would require the European Union and its member states to almost double their current ODA in nominal terms by 2015. According to EU estimations (EU, 2013), there is a significant risk for this decline in ODA to continue beyond 2015. In addition, recent turmoil in the Central African Republic and South Sudan combined with the lingering tensions and instability across the Sahel might lead to a reallocation of ODA.

### Box 2.2. **Development finance flows: The case of European development finance institutions**

The development finance landscape has changed dramatically in recent years. African countries are now able to draw from a wide range of development finance options in addition to aid from traditional donors, e.g. the official development assistance (ODA) provided by countries belonging to the OECD Development Assistance Committee (DAC). A number of alternative providers have gained significance, such as China and other non-DAC donors (AfDB et al., 2011), philanthropic organisations, and non-governmental organisations. DAC member countries have also been stepping up their supply of non-ODA development finance. One of their objectives is to contribute to financing activities that are not ODA-eligible and yet are essential to the transformation process of recipient countries, such as private sector development.

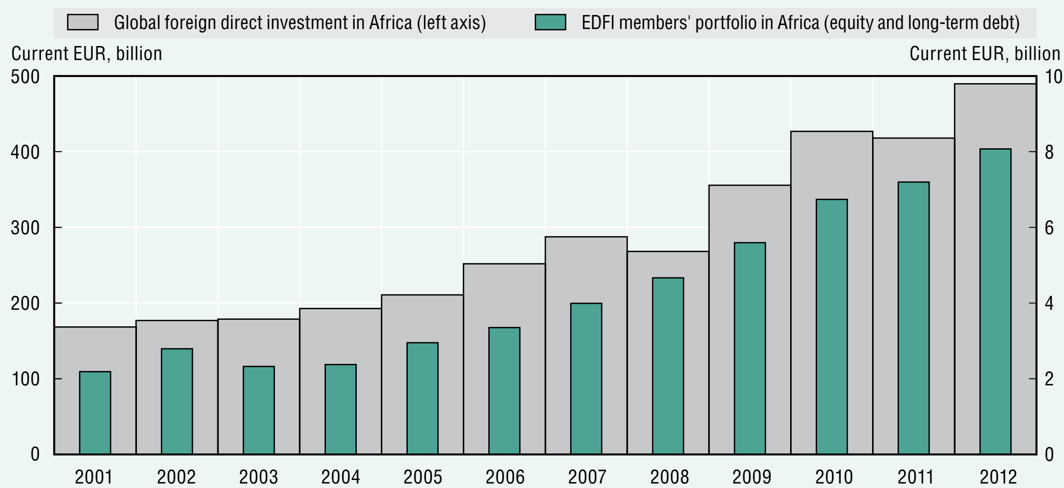
Small- and medium-sized enterprises, the missing link in the African economic fabric, struggle to find adequate sources of funding as their access to capital markets is limited. Typically, small entrepreneurs in Africa may have access to microfinance schemes, and big firms can draw from local or international banks and financial markets. National development finance institutions aim to bridge the gap between commercial investment and government aid, while avoiding market distortions. They have a developmental mandate and the obligation to remain financially viable; therefore they generally charge market rates to promote crowding-in of new funds. To catalyse private investment, they use loans, equity and guarantees as well as other risk mitigation instruments, such as mezzanine finance, syndicated loans and private equity via investment funds. Like other international financial institutions supporting private-sector development in Africa and in other regions – e.g. the African Development Bank, the International Financial Corporation and the Multinational Investment Guarantee Agency of the World Bank Group – development finance institutions can be considered complementary to traditional aid agencies and the public sector branches of multilateral development banks.

Fifteen European development finance institutions are today members of the Association of European Development Finance Institutions (EDFI) which was created in 1992 (www.edfi.be). Africa makes up about one third of their aggregated portfolio, i.e. around EUR 8 billion out of a total EUR 26 billion invested into 4 705 projects globally at the end of 2012. Equity investments make up slightly more than half of those EUR 8 billion, with the other half dominated by loans. For larger projects, EDFIs can pool resources: In 2003, EDFI members and the European Investment Bank (EIB) created European Financing Partners S.A. through which the parties pool and channel funding to projects in the African, Caribbean and Pacific Group of States. In 2011, EDFI members, the EIB and the Agence française de développement created the Interact Climate Change Facility; this facility pools and channels the parties' funding to renewable energy and energy efficiency projects in developing countries and emerging markets globally. FMO (The Netherlands) and DEG (Germany) set up a joint office in South Africa. The financial sector and infrastructure make up the bulk of the projects. Environmental and social standards typically

Box 2.2. **Development finance flows: The case of European development finance institutions** (cont.)

play a key role in project selection. Development finance institutions usually complement the financing provided by the sponsor and other commercial investors in a given project aiming at a multiplying effect. Results are measured in terms of job creation, public tax revenues, net foreign exchange effects, as well as sector specific outcomes, such as the increase of energy supply. For example, DEG committed EUR 1.45 billion in 2013 towards investments with a total volume of EUR 8.2 billion. DEG expects the operations it supports to create 30 000 new jobs, contribute more than EUR 800 million annually to public revenues and generate EUR 3 billion in net currency earnings per year. In Africa, DEG committed EUR 326 million. The contribution is expected to create 2 200 new jobs, contribute more than EUR 115 million annually to public revenues and generate approximately EUR 430 million in net currency earnings per year.

Figure 2.9. **EDFI portfolio and global foreign direct investment in Africa, 2001-12**




*Source*: Dalberg (2010, 2012).
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## Tax revenues in Africa continue to increase

This section analyses the performance of tax revenues in Africa from 2000 to 2012. It is based on the latest available data collected by the AfDB through the African Economic Outlook's annual country missions. The section discusses the importance of taxes for sustainable development. It describes the trends in tax revenue as well as the challenges faced by African countries to raise more and better taxes. It also highlights the paradox of declining official development assistance to support tax systems against evidence of the strong increases in tax revenues it generates. It argues that tax revenues should not be seen as an alternative to foreign aid but as a component of government revenues that grows as the country develops.

### Taxation plays a central role in promoting Africa's sustainable development

Domestic financial resources for development have become increasingly important for developing countries and development partners alike. Already in 2002 the Monterrey Consensus highlighted the importance of mobilising domestic resources to finance the Millennium Development Goals. Since Monterrey two important follow-ups: the Doha Declaration on Financing for Development (2008) and the Busan Partnership for Effective Development Co-operation (2011) have encouraged a greater role for taxation to fund

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development. In the long run, greater domestic investment can offset vulnerability as well as strengthen local ownership.

Taxation provides governments with the funds needed to invest in infrastructure, relieve poverty and deliver public services. As such, taxes play an important role in consolidating a well-functioning state but should not become an end in themselves (Kaldor, 1980; Toye, 1978). A healthy public finance system is needed for rapid, equitable and sustainable growth: government revenue should adequately finance basic security, education, health services and public investment while avoiding inflationary financing (Di John, 2009). Strengthening domestic resources offers an antidote to aid dependence and increases the country's ownership of its development and growth agenda.

Yet, in 2012 low-income African countries on average still mobilised only around 16.8% of their GDP in tax revenues, below the minimum level of 20% considered by the United Nations as necessary to achieve the Millennium Development Goals (UNDP, 2010). Lower-middle-income African countries fared little better, with an average tax burden – the share of tax revenues to GDP – of 19.9% in 2012. With an average tax burden of 34.4% in 2012, upper-middle-income countries came closer to the average in OECD countries of 35%. For comparison, in 2000, the tax burden equalled 12.6%, 20.9% and 28.0% for respectively low-income countries, lower-middle-income countries and upper-middle-income countries. For Africa as a whole, the tax burden stood at 26.0% of GDP in 2012, compared to 24.4% in 2011.

Not only do states rely on tax revenues to function, but taxes are also the primary platform for political negotiations among a country's stakeholders. They are part of the social contract between a state and its citizens: taxpayers want to know that everyone is paying their fair share and that the money they hand over is put to good use and delivers a return in the form of public services. They are more likely to comply with paying taxes and accepting new forms of taxation if they consider the taxes to be legitimate. This is known as fiscal legitimacy. Fair and efficient taxation catalyses state building and enhances accountability between citizens and the state.

### Revenue from natural resources underpin the increase in tax revenues in Africa

According to data collected for this edition of the *African Economic Outlook*, total collected tax revenue in Africa increased four-fold from USD 137.5 billion in 2000 to a record USD 527.3 billion in 2012. This equals an increase of 12.8% compared to the USD 467.4 billion in 2011. The category "other taxes", which is largely composed of natural-resource-related tax revenue, underpinned this strong increase (Figure 2.10). In 2012 other taxes represented USD 242 billion, amounting to 46% of total tax revenue in Africa. Their share increased from an average of 40% for the period 2000-05 to an average of 43% in 2008-12.

A limited number of African countries accounted for the majority of taxes collected. In 2012 the five largest tax collectors were South Africa (USD 98.6 billion), Algeria (USD 79.5 billion), Nigeria (USD 75 billion), Libya (USD 53.7 billion) and Angola (USD 50.7 billion). The recovery of oil production in Libya underpinned the USD 40 billion increase in the country's tax collection, back to the level of 2008. From these major contributors to tax revenues in Africa, South Africa is the only country that saw its tax revenue diminish across all categories in 2012. In total, South Africa collected USD 3.5 billion less taxes.

Figure 2.10 illustrates that there are large differences in the tax mix patterns in Africa – the tax mix being the relative composition of a country's tax revenues. A country like South Africa obtains most of its tax revenues from direct taxation, while countries

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like Senegal and Uganda rely mostly on indirect taxation. Kenya and Mauritania show a relatively balanced mix of different types of taxes. Other countries, however, such as Angola, Equatorial Guinea, Libya and Nigeria almost entirely rely on one single type of tax.

Figure 2.10. **The tax mix of different country income groupings in Africa, 1996-2012**

Direct taxes | Indirect taxes | Trade taxes | Other taxes

Low-income countries

Lower-middle-income countries

Upper-middle-income countries

*Source*: African Economic Outlook data.

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Trade taxes refer to taxes levied at the border. These are mainly import tariffs and export duties, although export duties have almost largely disappeared. Trade taxes have declined in upper-middle-income and lower-middle-income countries, while trade tax revenue in low-income countries has remained stable as a share of GDP.

A balanced tax mix is important to ensure stable and predictable tax revenues to fund public service delivery and investments. Direct income taxes and indirect value added taxes tend to be more stable than resource-related taxes. Resource-related tax revenues tend to be dependent on fluctuating international resource prices and demand. Many of Africa's middle-income countries are endowed with natural resources, which explains the higher share of other taxes in their tax mix. Low-income countries have made significant progress in raising tax collection through direct and indirect taxes.

The effect of fluctuating resource prices since 2008 and onwards throughout the crisis can also be seen in Figure 2.10. Direct taxes, indirect taxes and trade taxes as a percentage of GDP have remained nearly constant, whereas the category "other taxes" accounted for close to the entire increase of the tax ratio for middle-income countries. Total tax revenues in Africa peaked to USD 458.5 billion in 2008 following the increase in oil and non-oil commodity prices in 2008 before dropping by 26% over 2009. For comparison, this decrease in tax revenues equalled USD 119 billion, roughly the sum of official development assistance and foreign direct investment that year.

**Many African countries continue to face severe challenges to further raising their tax revenues**

Most African economies are characterised by a shallow tax base. This is largely the result of weak tax administrations, which continue to be staffed by poorly trained and low-paid officials. The administrative structures do not encourage an integrated approach to different taxes and are hampered by imbalanced service and enforcement functions. These severe capacity constraints of tax administrations combined with the lack of fiscal legitimacy of the state result in an unbalanced tax structure relying mostly on a narrow set of taxes to generate revenues.

In addition, most African economies are characterised by large hard-to-tax sectors, such as small enterprises, farms and a high level of informality. The informal economy – workers and companies operating outside the reach of the law or public administration – is a major obstacle to broadening the tax base and collecting direct taxes. This poses a wide range of economic challenges: not only are taxes not collected, but informal firms are also often less productive and offer no labour or social protection schemes for workers. In short, high informality leads to lower economic growth and greater social exclusion (Jütting and de Laiglesia, 2009).

Also, the tax base can be further eroded by competition for investment between African countries. Ineffective tax incentives are no compensation for a poor investment climate and may actually damage a developing country's revenue base, eroding resources for the real drivers of investment decisions: infrastructure, education and security. Governments may perceive a threat from investors choosing neighbouring countries, triggering "a race to the bottom" that makes countries in a region collectively worse off.

A more open international trading system is adding new challenges to mobilise domestic resources. Multinationals may take advantage of the different tax regimes across countries where they have subsidiaries to maximise after-tax profits. One way in which multinational enterprises may try to benefit from their international presence is misuse of transfer pricing, e.g. by artificially shifting taxable profits from high-tax to low-tax jurisdictions. This happens when firms under- or over-invoice for goods,

services, intangibles or financial transactions between entities situated in different tax jurisdictions.

According to the IMF et al. (2011), African tax authorities "face challenges in designing and implementing effective transfer pricing and information exchange regimes and more generally in improving transparency". Box 2.3 describes an innovative way to strengthen tax audit capacity in African tax authorities, giving them the means and technical capacity to deal with the complexities of the practice.

Box 2.3. **Tax Inspectors Without Borders: an innovative approach to improve audit skills**

Developing countries and development partners have for a long time identified the mobilisation of domestic financial resources for development as a priority, and in a changing era, taxation has taken on a higher profile as a means to support this goal. The demand for assistance from developing countries is changing too, as globalisation poses new challenges and opportunities in international taxation, particularly transfer pricing and tax information exchange. On the supply side, many countries that were once aid recipients now actively provide assistance themselves on tax matters, adding a positive dynamic to international knowledge building.

Against this background, the Tax Inspectors Without Borders (TIWB) concept was proposed. TIWB facilitates targeted, tax audit assistance programmes in developing countries across the globe. Tax audit experts work directly with local officials in developing country tax administrations on current audits and audit-related issues concerning international tax matters and share general audit practices for specific cases.

TIWB offers a new form of direct assistance, facilitating programmes that use a real-time, "learning by doing" approach to solve current audit issues and to transfer knowledge and skills. TIWB programs complement existing training by introducing a real-life, practical component. Using the TIWB tools to put in place a simple but effective framework to address potential issues such as confidentiality and conflict of interest, experts can now work on audit files alongside local tax officials.

TIWB began on a trial operational basis at the end of 2013, with a number of pilot projects planned for 2014. Recent programmes of similar audit assistance have had strong results in terms of increases in tax revenues. Beyond revenues, TIWB programmes through the skills transfer process aim more broadly to improve the quality and consistency of tax audits and increasing confidence in the tax administration.

*Source*: OECD Task Force on Tax and Development (2014).

The *African Economic Outlook 2010* signalled the importance of the proper sequencing of policy reform. The tax base needs to be deepened in the short run by limiting tax preferences and negotiating fairer taxation with multinationals, in combination with strengthening the capacity of the tax administration. In the long run African countries will need to improve the tax balance between different taxes. This can be facilitated by strengthening the fiscal legitimacy of the state, which must be accompanied by a public debate on better governance, transparency and the usage of the increased public resources for the government.

### A dollar spent on tax systems can generate several dollars in collected taxes

According to the president of the African Tax Administration Forum, Oupa Magashula, at the OECD Global Forum on Development in January 2010, aid can have up to "a tenfold multiplier effect on states' resources". An additional benefit for the government is the

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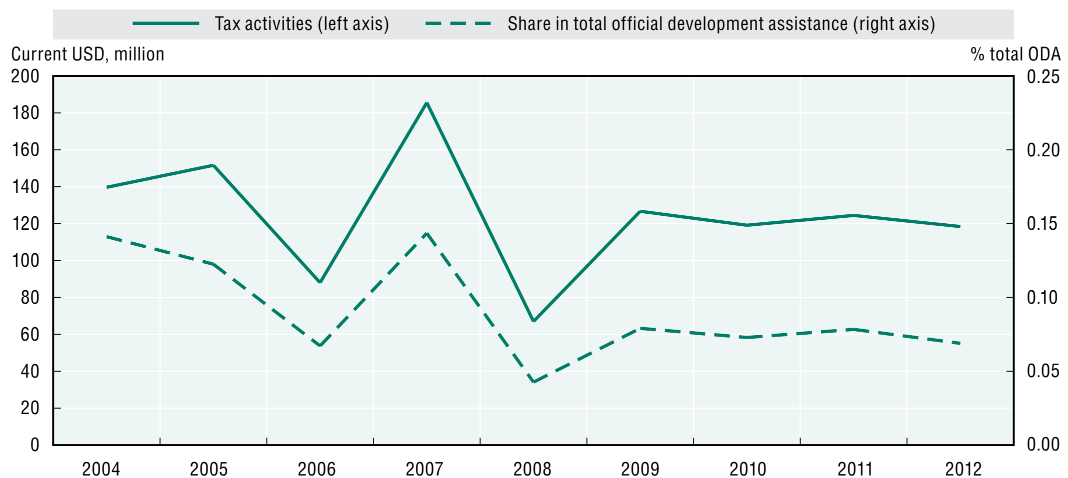
accumulation of data collected in the process of bringing in taxes, which expands the knowledge base for general macroeconomic and development planning. Conversely, the multiplier effect does not factor in the cost of collecting tax revenues in terms of lost economic efficiency, as taxes always distort economic decisions on investment, savings, or labour in some way.

Paradoxically, despite the rhetoric by the donors about the importance of tax revenues, aid to support tax activities has remained marginal in the overall aid provided to African countries. Figure 2.11 shows the decreasing amount of support for tax activities since 2004. Against the multiple evidence that supporting tax reforms can yield strong returns in tax revenue, donors will have to provide more and better development co-operation to strengthen domestic resource mobilisation in African countries.

Figure 2.11. **Global official development assistance commitments to tax and tax-related activities, 2004-12**




*Note*: The data do not include figures from the IMF.

*Source*: OECD (2014b).

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### Notes

1. Total external financial flows include official development assistance, private portfolio and equity investment and remittances. They do not include other official flows, trade credits or loans from commercial banks. On non-ODA official flows, see Box 2.2.
2. The Gulf Co-operation Council includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.
3. Brazil, Russia, India, China and South Africa.
4. Portfolio stocks are measured at a specific time and represent the total quantity of portfolio investments accumulated in the past.
5. The IMF Coordinated Portfolio Investment Survey (CPIS) collects information on the stock of cross-border holdings of equities and debt securities from 75 investor countries and territories.
6. According to Freund and Spatafora (2005), up to a share of 75% of total remittances to Africa are not officially recorded. This share is larger than for other continents.
7. Taking account of both inflation and exchange rate movements.
8. For more information, see www.oecd.org/dac/aidarchitecture/cpa.html.



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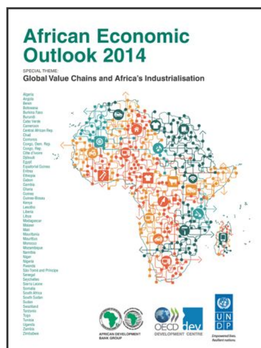

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