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THE IMPACT OF CAPITAL MOBILITY ON DOMESTIC REVENUE IN SUB-SAHARAN AFRICA

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Abstract

This paper examines the impact of capita mobility on domestic revenue in developing countries. It discusses some ideas about how we should look at international tax policy in the face of reality of globalization. The process of improving tax system, illicit capital flight and trade liberalization are part of the challenges facing developing countries in the world today. The method employed is exploratory based on the theoretical review of the various authors' work. It was found out that large corporations and wealthy individuals are increasingly avoiding their obligation to contribute to the society through taxation as a result of illicit capital flight and tax incentives granted. It was therefore recommended that governments should discourage tax incentives in attracting Foreign Direct Investment, increase revenues, refocus government spending on public priorities and introduce more stringent taxes on environmental pollution.

Keywords: Capital flight, Domestic tax systems, Globalization, mobility, Tax Incentives

Introduction

Tax policies have been developed primarily to address domestic economic and social concerns. A tax is a charged or levied by a government on a product, income, or activity. The main reason for taxation is to finance government expenditure and to redistribute wealth which translates to financing the development of the country (Ola, 2001, Jhingan, 2004, Musgrave & Musgrave, 2004, Bhartia, 2009). The taxes collected may not be sufficient to finance the needs of the government, therefore, the government can also seek alternative sources of revenue to finance sustainable development (Ola, 2001). However, domestic revenue mobilization as a source of financing developmental activities in developing countries has been a difficult issue primarily because of various forms of resistance, such as evasion, avoidance and corrupt practices. These activities are considered as sabotaging the economy and are causes for the underdevelopment of the country. The use of tax as an instrument of fiscal policy to achieve economic growth in most developing countries is not bringing desired results because of the dwindling level of revenue generation.

Consequently, upon this, fine-tuning tax rates have been used to influence or achieve macroeconomic stability. Developed countries derive substantial revenue from Company Income Tax, Value Added Tax, Import Duties and have

used the same to create prosperity (Oluba 2008). However, in Nigeria the contribution of tax revenue has not been encouraging, thus expectations of government are being cut short. Corruption, evasion, avoidance and tax haven indicators are strongly associated with low revenue (Attila, Chambas, & Combes, 2008). According to Adegbie & Fakile, (2011), the more citizens lack knowledge or education about taxation in the country, the greater the desire and the opportunities for tax evasion, avoidance and non-compliance with relevant tax laws. Therefore, there is a need for tax administrators to recognize the importance of communication and dialogue between the government and the citizens in matters relating to taxation.

Domestic tax systems of closed economies had an international dimension in that they affect the amount of tax imposed on foreign sourced income of domestic residents. The increasing growth of globalization of trade and investment has fundamentally changed the relationship among domestic tax systems. Globalization has been one of the driving forces behind tax reforms, which have focused on wide coverage and rate reductions, thereby minimizing tax induced distortions. It has encouraged nations around the world to constantly review their tax systems and public spending with a view to making necessary amendments where necessary to attract investment, promote mobility of capital for development, financial markets, and sometimes cause countries to reduce tax barriers to developments.

Literature Review

Tax incentives are common around the world, especially in developing countries. Governments try to attract domestic and foreign capital using tax incentives by given more favorable tax relief to certain economic activities. This relief can be in the form of reduced corporate income tax rates, tax holidays, tax deductions through tax credits or investment allowances, and so on. In any case, the use of tax incentives in developing countries is controversial, as they come with great and sometimes overlooked financial and welfare costs most especially if not properly designed. The theoretical work that explains why investment would react on tax incentives goes back to the neoclassical investment theory, pioneered by Jorgenson (1963). The basic argument goes that firms accumulate capital as long as the benefits exceed the costs. According to this theory, if tax reductions decrease the user cost of capital, investment goes up.

The existing empirical literature on the relationship between taxes and investment has generally found that taxes have significant effects (Hassett, Kevin & Mathur, 2006). The international tax competition literature has been tested by estimating strategic tax reaction functions, in which the tax rate of one jurisdiction depends on the weighted average of the tax rates in the other competing jurisdictions.There are very few studies which have been conducted to see the impact of tax revenue on economic development. Experts of group United Nations (2000) stated that, tax revenue contributes substantially to development and therefore, there is the need to streamline a nation tax system so as to ensure the realization of optimal tax revenue through equitable and fair distribution of the tax burden. The stark reality in most developing countries is that whilst there is severe budgetary pressure as a result of ever increasing demand for government expenditure, there is also a limited scope for raising extra tax revenues, as a result of Non-compliance and tax avoidance, poor record keeping and cash transactions.

Keen and Mansour (2010), in analysing the revenue mobilization in sub-Saharan-Africa found that, within sub-Saharan Africa, revenue has performed more strongly in resource-rich countries. In the same vein, Desai, Foley & Hines (2004) stated that governments have at their disposal many tax instruments that can be used to finance their activities. These tax alternatives include personal and corporate income taxes, sales taxes, value added taxes, capital gain taxes and others. It is not uncommon for a country to impose all of these taxes simultaneously. Contrarily, in choosing what tax instruments to use and what rates to impose, governments are typically influenced by their expectations of the effects of taxation on investment and economic activity, including foreign direct investment (FDI). They stated that there is extensive empirical study that high corporate income tax rates are associated with low levels of FDI.

On the issue of the problem of tax revenue instability, Lim (1983) in his study, instability of government revenue and expenditure in less developed countries, observed that tax revenues instability was the major cause of expenditure instability in less developed countries.Ebeke & Ehrhart(2010) in their work, the sources and consequences of the instability of tax revenue in Sub-Saharan African countries, using panel for 39 countries over the period 1980-2005, gave credence to Fatas & Mihov, (2003), Talvi & Vegh (2005), Furceri (2007), Thorthon (2008) and Diallo (2009), that tax

revenues instability in Sub-Saharan Africa is leading to public investment and government consumption instability which in turn generates lower public investment ratio and is therefore detrimental to the long term economic growth.

Tax Incentives

The process of using tax incentives to attract domestic and foreign capital is discussed below.

(i) Granting tax holidays especially company income tax, waiving administrative requirements such as filing tax returns.
(ii) Encourage rural industrialization by granting of exemption on various forms of taxes to industries located in rural areas.
(iii) Due to the mobility of capital, globalization and competition among nations to attract Foreign Direct Investments, there is always the temptation of reducing company income tax rate.
(iv) Granting exemptions such as import duty, value added tax, environmental tax and so on to companies on imported inputs.
(v) Provide financial incentives by not charging withholding taxes on dividends to providers of funds.

Impact of Globalization on Domestic Revenue

Taxation is important in meeting the developmental needs of Sub-Saharan Africa (SSA) (Glenday, 2006). The average tax-to-GDP ratio in Sub-Saharan Africa has increased slightly from less than 15% of GDP in 1980 to more than 18% in 2005 (Keen & Mansour, 2010). The effects of globalization on domestic revenue could be seen from the following:

Trade liberalization

Tariffs from international trade accounted for greater share of government revenue in many African countries and today up to 30% of non-resource tax revenue (4% of GDP) is raised through tariffs and trade related taxes (Baunsgaard & Keen, 2010).Figure 1 below illustrates, that the trends of decreases in revenues from trade is much less significant, and that intra-regional trade only amounts to 10% of Africa's taxes. This obviously presents a major challenge to maintaining current revenue bases, let alone increasing them. Alternative revenue sources need to be available before tariffs are phased out. This is especially true for Africa in the context of the Economic Partnership Agreements (EPAs) with the European Union, as exchanges with the latter traditionally represent roughly two-thirds of African external trade (Baunsgaard & Keen, 2010).

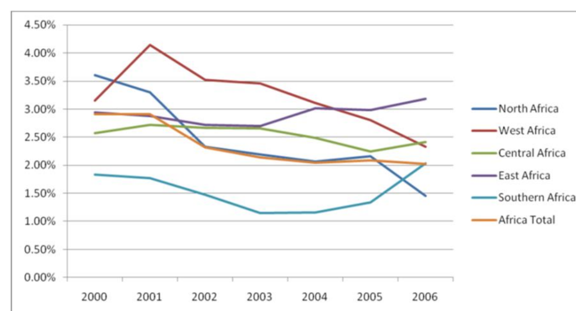

Figure 1: Trade tax in Africa as % of GDP

Source: OECD Development Centre (2009)

Transfer Pricing and Illicit Capital Flight:

This is a major concern for many developing economies because international financial liberalization continues to encourage capital flight to onshore and offshore financial centres. Tax Justice Network has estimated that capital flight from all countries, including funds undeclared in the country of residence, is approximately US$11.5 trillion (Spencer, 2006; Christensen & Murphy 2004). Annual global income from such sources is conservatively estimated at US$860 billion, and the annual world-wide tax revenue lost is approximately US$255 billion, which equals the funds estimated to meet the UN Millennium Development Goals (Christensen & Murphy 2004).

Estimates presented in Table 2 below show that over the 39-year period Africa lost an astonishing US$854 billion in cumulative capital flight—enough to not only wipe out the region's total external debt outstanding of around US$250 billion (at end of December, 2008) but potentially leave US$600 billion for poverty alleviation and economic growth. Instead, cumulative illicit flows from the continent increased from about US$57 billion in the decade of the 1970s to US$437 billion over the nine years 2000-2008 (GFI, 2012). The overwhelming bulk of this loss in capital through illicit channels over the period 1970-2008 was from Sub-Saharan African countries, there are significant disparities in the regional pattern of illicit flows. Table 2 also shows that real illicit flows from Africa grew at an average rate of 12.1 percent per annum over the 39-year period. The rates of outflow in illicit capital for West and Central Africa (14.5 percent) as well as fuel-exporters (21.8 percent) over the entire period 1970-2008 reflect substantial outflows from Nigeria and Sudan.

Table 2: Africa: Illicit Financial Flows, 1970-2008 (in millions of U.S. Dollars)

Group	**Total IFFs**				
	1970s	1980s	1990s	2000-2008	1970-2008
Africa	**57,291**	**203,859**	**155,740**	**437,171**	**854,061**
North Africa	19,161	72,020	59,813	78,742	229,737
Sub-Saharan	38,130	131,839	95,927	358,429	624,324
Horn of Africa	2,354	14,131	5,108	15,603	37,197
Great Lakes	6,925	16,079	4,978	10,285	38,267
Southern	5,894	20,581	31,447	116,828	174,751
West and Central	22,956	81,047	54,394	215,712	374,109
Fuel-exporters	20,105	67,685	48,157	218,970	354,917
Nonfuel-exporters	7,867	26,517	22,375	23,342	80,102
Group	**Average IFFs**				
	1970s	1980s	1990s	2000-2008	1970-2008
Africa	**7,299**	**21,678**	**17,813**	**50,328**	**29,021**
North Africa	3,097	7,754	6,316	9,166	6,866
Sub-Saharan	4,202	13,924	11,497	41,162	22,156
Horn of Africa	249	1,421	715	1,949	1,183
Great Lakes	745	1,778	580	1,286	1,142
Southern	811	2,412	4,659	13,388	9,635
West and Central	2,397	8,313	5,544	24,538	10,196
Fuel-exporters	2,239	6,922	5,105	24,806	9,878
Nonfuel-exporters	1,017	2,729	2,433	2,787	2,502
Group	**Rates of Change (real 2008 CPI deflated)**				
	1975-1979	1980s	1990s	2000-2008	1970-2008
Africa	**18.9**	**-2.1**	**-4.8**	**24.6**	**12.1**
North Africa	14.0	-11.5	0.5	6.0	6.5
Sub-Saharan	n.a	1.3	-7.0	30.1	15.1
Horn of Africa	n.a	7.3	-15.5	33.5	20.0
Great Lakes	13.2	-12.7	-17.7	35.0	13.5
Southern	n.a	13.5	7.3	21.5	16.7

West and Central	21.5	0.0	-11.4	36.0	14.5
Fuel-exporters	n.a	2.2	-15.6	42.6	21.8
Nonfuel-exporters	n.a	11.3	-1.6	11.0	13.6

Source: GFI (2012)

Tax Expenditure for Foreign Direct Investment (FDI)

Competition among developing countries for foreign direct investment has forced many developing countries to use special tax incentives like tax holidays, investment allowances, free enterprise zones or tax sparing provisions. But a dataset collected by Keen and Mansour (2010), which covers 40 Sub-Saharan African countries does suggest that the use of tax incentives for investment has increased over the last decades. For instance, in 1980, only one among the 29 countries for whom data are available offered free zones, where special corporate income tax treatment is offered. In 2005, almost half of the countries covered by the dataset offered this type of incentives. Table 3 gives an overview over the different types of tax incentives reported by Keen and Mansour (2010) and their change over time. In the literature, the growing use of tax incentives for investment in developing countries is criticized for various reasons. One issue is that these tax incentives reduce corporate income tax revenue (Bird, 2008; Klemm, 2009).

Table 3: Investment Tax Incentives in sub-Saharan African Countries 1980 and 2005

	1980			2005		
	Number of Countries Offering Incentives (I)	Total Number of Countries (2)	Ratio (1)/(2)	Number of Countries Offering Incentives (I)	Total Number of Countries (2)	Ratio (1)/(2)
Tax Holidays	13	29	0.45	27	39	0.69
Reduced CIT Rates	3	29	0.1	20	39	0.51
Investment Allowances	17	29	0.59	22	39	0.56
Incentives for Exports	3	29	0.1	11	39	0.28
Free Zones	1	29	0.03	18	39	0.46
Investment Code	9	29	3.1	29	39	0.74

Source: Keen and Mansour (2009)

The table 4 below shows the summary of duty loss in Nigeria to all concessions between January 2004 and November 2006. From the table, revenue loss in 2004 was N56.8billion which increased to N71.2billion in 2005 and reduced to N54.9billion in 2006.This is an evidence to show that the government is losing much revenue annually which will definitely affect negatively the provision of essential needs for the growth and development of Nigerian economy.

Table 4: Revenue Loss by Nigerian Customs Services from 2004 – 2006 in Naira

SN Exemption/Concession	2006 N	2005 N	2004 N
1. Revenue loss due to exemption /waivers	18,237,049,659.54	41,636,157,785.94	33,970,745,310.37
2. Revenue loss due to ETLS	1,494,223,772.13	2,548,734,595.82	2,104,089,331.98
3. Revenue loss due to concessionary Duty rate granted bonafide Manufacture/Assemblies	564,956,189.29	10,001,804,163.24	6,982,047,350.65
4. Revenue loss due to export Processing/excise factory	256,055,157.07	248,545,281.21	146,279,457.67
5. Revenue loss due to concessions to Manufacture-In-Bond-Schemes (MIBS)	3,819,378.39	820,147,347.45	1,115,233,719.64
6. NDCC	34,365,839,307.46	15,989,292,537.74	11,478,137,655.38
TOTAL	**54,921,943,464.88**	**71,244,681,711.40**	**56,796,532,825.67**

Source: Adapted from Buba, (2007)

Steps toward achieving Global Tax Justice

Developing countries including Nigeria lose billions of dollars through tax evasion, tax avoidance and inefficient fiscal authorities. A large portion of the already scarce revenues goes toward military expenditures, harmful subsidies and debt repayment, none of which contribute toward alleviating poverty and promoting sustainable development. The following are steps toward achieving global tax justice:

(i) Investment in Human Capital
(ii) Tax compliance as Corporate Accountability.
(iii) Fight Bribery and Corruption
(iv) Stopping unnecessary pressure on developing countries to liberalize trade

Conclusion

This paper has examined the impact of globalization on the domestic revenue tax system in developing countries; and the extent to which the capital is mobile internationally and how the mobility of capital has resulted in tax competition. The cost of tax incentives may be greater than expected because of tax avoidance schemes set up to exploit them. Tax avoidance now occurs on a massive global scale. This threatens democracy and sustainable development, hence, the need to build global and national campaigns for tax justice.

Recommendations

To strengthen the domestic revenue tax system in developing countries through globalization, the following recommendations are proffered:

i] Governments should discourage tax incentives granted to attract FDI, especially in the area of tax holidays.
ii] Tax expenditures must be audited and published with comprehensive analysis to ensure fiscal transparency.
iii] Integrating tax expenditures into the budget process by subjecting them to effective legislative controls in order to avoid a debt crisis.
iv] The necessary fiscal reforms to achieve this should not only function to mobilize more money but should at the same time pursue active redistribution policies to the benefit of the poor.
v] Introduction of more stringent taxation of environmental pollution in order to encourage more environmentally friendly production and consumption patterns.
vi] Multilateral cooperation should be strengthened so as to repatriate embezzled money from foreign bank accounts to developing countries.

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