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Why Has Domestic Revenue Stagnated in Low-Income Countries?

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There has been miserably slow progress in increasing domestic revenue in low-income countries since the 1990s. In order to find out why, this Development Viewpoint draws on an extensive analysis of disaggregated revenue data for low-income countries in sub-Saharan Africa, South and Southeast Asia, and Central Asia. See the background CDPR Discussion Paper 27/09 (McKinley and Kyrili 2009).

Based on this analysis, we contend that the reigning 'tax consensus' has placed an inordinate emphasis on boosting domestic indirect taxes, and the value added tax (VAT) in particular. These taxes cover domestic goods and services in the formal sector.

At the same time, the 'consensus' has advocated eliminating import taxes (in order to liberalise trade) and lowering tax rates on corporate profits (in order to compete with other rate-cutting countries). Consequently, trade taxes have been particularly hard hit while increases in direct taxes, which cover mainly personal income and corporate profits, have generally been anaemic.

Overall revenue has ended up stagnating because of the resultant reliance on boosting revenue from only one major component, i.e., taxes on domestic goods and services. The pre-eminent instrument for this purpose has been the VAT, which has replaced sales taxes (as well as import duties) in many countries.

Our analysis is based on data on overall revenue and its three major components (trade taxes, domestic direct taxes and domestic indirect taxes) for the period 1990-2006. Because of our focus on sustained progress in revenue mobilisation, we compare averages for the sub-periods of 1990-94, 1995-99 and 2000-06.

Utilising the recommendation of the UN report, *Investing in Development*, as our starting point, we have chosen as our threshold of success a 5-percentage-point increase in overall revenue over the whole period, and a 3-percentage-point increase over the latter two periods.

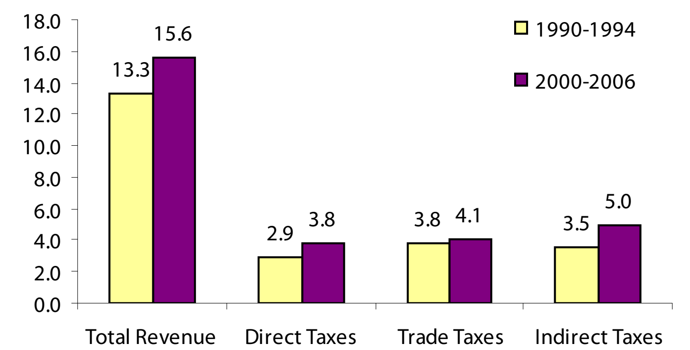
Revenue Trends in Sub-Saharan Africa

First we examine the record of 29 low-income countries in sub-Saharan Africa. Total revenue in these countries only increased from 13.3% of GDP during 1990-94 to 15.6% during 2000-06—or by 2.3 percentage points, less than half our 5-percentage-point benchmark of success (Figure 1). This total includes a 0.3-percentage-point increase in nontax revenue.

Overall progress on revenue was very slow during the 1990s, and was still only moderate during the 2000s, when both incomes and exports were definitely trending upwards in the region.

What was holding back progress? Trade taxes barely rose. They registered a mere 0.3-percentage-point increase over the whole period, edging up from 3.8% of GDP to 4.1%. Direct taxes rose by only 0.9 percentage point—namely, from 2.9% of GDP to 3.8%.

Figure 1: Sub-Saharan Africa Revenue Trends



Source: IMF Statistical Appendices of Article IV Consultations, various years

Domestic indirect taxes, such as the VAT, rose by the most, that is, by 1.5 percentage points—i.e., from 3.5% of GDP to 5.0%. Had the other two major components performed similarly, the low-income countries in Africa would have come close to the benchmark goal of 5 percentage points.**

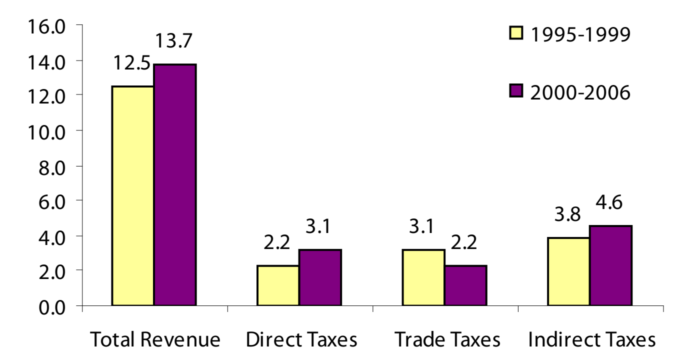
Revenue Tends in South and Southeast Asia

There are far fewer low-income countries in Asia than in Africa. We have been able to assemble relevant revenue data for seven such countries in South and Southeast Asia (Bangladesh, Cambodia, India, Lao PDR, Nepal, Pakistan and Vietnam).

Because of the lack of comprehensive data for 1990-94, we focus our attention on the trend between 1995-99 and 2000-06. Hence, we use a 3-percentage-point increase as the benchmark of success.

Surprisingly, the average levels of revenue in South and Southeast Asia have been relatively low compared to those in sub-Saharan Africa (Figure 2).

Figure 2: South/ Southeast Asia Revenue Trends



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Additionally, total revenue has increased slowly—from an average of 12.5% of GDP during 1995-99 to only 13.7% of GDP during 2000-06, or by a meagre 1.2 percentage points (Figure 2). This is less than half our benchmark. Moreover, the increase in nontax revenue accounted for a 0.4 percentage point of the total.

Advances in total revenue were very slow despite the healthy rates of regional GDP growth during the two periods, i.e., 5.7% during 1995-99 and 6.4% during 2000-06. So, which tax components were most responsible for the slow progress?

Direct taxes did increase faster in Asia than in Africa. They increased from 2.2% of GDP to 3.1% of GDP, or by 0.9 percentage point—an absolute increase that Africa managed to achieve only over a much longer period.

Domestic indirect taxes also did moderately well, increasing from 3.8% of GDP to 4.6% of GDP, or by 0.8 percentage point. This is comparable to the 1.5-percentage-point increase of this component in sub-Saharan Africa over a period almost twice as long.

Trade taxes *declined*, however, by 0.9 percentage point, reaching 2.2% during 2000-06. This decline occurred at the same time that aggregate imports for these countries rose from 31.9% of GDP to 37.6%. This suggests that trade liberalisation was carried out more intensively in Asia than in Africa.

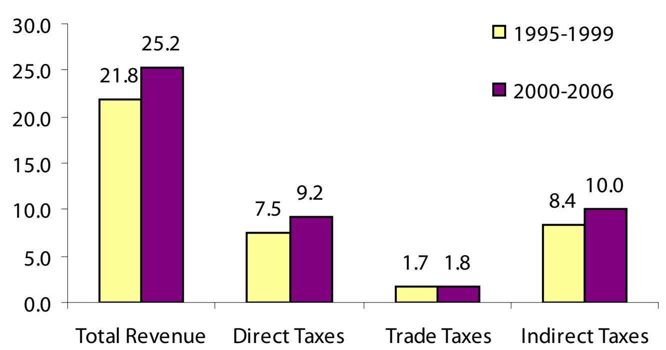
The 0.9-percentage-point setback in trade taxes effectively cancelled out over half the 1.7-percentage-point increase of the other two components. As a result, general progress on revenue in South and Southeast Asia ended up being slower, overall, than in sub-Saharan Africa.

Revenue Trends in Central Asia
We have also been able to collect relevant revenue data for 1995-99 and 2000-06 for four low-income countries in Central Asia: Kyrgyz Republic, Mongolia (usually considered part of East Asia), Tajikistan and Uzbekistan.

Since all of these countries experienced sharp drops in income per capita during the early 1990s, they were accordingly classified as low-income. But by the mid 1990s they had already regained above-average levels of revenue.

Between 1995-99 and 2000-06, they also continued to make significant progress (Figure 3).

Figure 3: Central Asia Revenue Trends



Their total revenue increased from 21.8% of GDP during 1995-99 to 25.2% during 2000-06, or by 3.4 percentage points.

The initial levels of both domestic direct and indirect taxes in 1995-99 in Central Asia were relatively high, i.e., 7.5% of GDP for direct taxes and 8.4% for indirect taxes. Compared to conditions in South and Southeast Asia or sub-Saharan Africa, these countries have had more formalised economies and greater state capacity.

In contrast, this region's trade taxes have been much lower than in the other two regions despite the fact that its imports have been well above 50% of GDP. These taxes started at only 1.7% of GDP during 1995-99, and inched up to only 1.8% during 2000-06.

But both domestic direct and domestic indirect taxes in this region rose significantly between 1995-99 and 2000-06—direct taxes by 1.7 percentage points of GDP and indirect taxes by 1.6 percentage points.

Undoubtedly, these increases have been attributable, in part, to much faster economic growth during the latter period, i.e., over 6%, compared to 1.6% in the earlier period. They have also been due to sizeable resource rents in some countries.

In fact, across the three regions, the countries most successful in generating revenue have been rich in oil or other such valuable resources.

Concluding Remarks
Except for the transition economies in Central Asia, progress on revenue mobilisation has been slow in both Asia and Africa. Trade taxes have either stagnated or declined, largely due to trade liberalisation. The speed of such liberalisation has been ill-advised. As a consequence, regional progress has hinged on marked advances in *both* direct taxes and indirect taxes.

However, increases in direct taxes have generally been unsatisfactory, due partly to widespread slashing of rates on corporate profits, based on the expectation that more profits would thereby be generated and hence more revenue collected. But the evidence of such an effect is weak or conflicts with such a rosy expectation.

These shortcomings have intensified the pressure on the VAT to become the main driving force of revenue advances. But the prevalence of large agricultural sectors and/or sizeable urban informal sectors in low-income countries has weakened the economy-wide effectiveness of such a consumption tax.

Our general conclusion is that core elements of the standard advice on how to generate domestic revenue in low-income countries are faulty. Thus, there is a pressing need to thoroughly re-evaluate that advice and a likelihood that its contents should be fundamentally re-designed.

References:

McKinley, Terry and Katerina Kyrili (2009). 'Is Stagnation of Domestic Revenue in Low-Income Countries Inevitable?' CDPR Discussion Paper 27/09.

*Ample credit should be given to Katerina Kyrili, the Research Officer of CDPR in early 2009, who was the co-author of the Discussion Paper on which this Development Viewpoint is based.

**The small tax component of 'other taxes', which comprises a miscellaneous set of fees and charges, is not reported here although this component declined in both sub-Saharan Africa and South and Southeast Asia during our period of analysis.