

# TaxDev

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# Fiscal consolidation after COVID-19: issues and policy options in sub-Saharan Africa



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# Preface

This report has been prepared by IFS researchers under the auspices of the Centre for Tax Analysis in Developing Countries (TaxDev). TaxDev aims to promote more effective tax policymaking in low- and middle-income countries through research, applied analysis, and partnerships with policymakers. Financial support for TaxDev via UKAID from the UK government is gratefully acknowledged.

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# Executive summary

Since Spring 2020, the COVID-19 pandemic has had significant impacts on the public finances of both developed and developing countries. Falls in revenues and increases in public expenditure have pushed up deficits and debts, posing a particular challenge for many countries in sub-Saharan Africa (SSA). After the debt relief of the 2000s, the 2010s saw public debt and debt-servicing costs grow substantially across the region, with the fiscal situation looking increasingly unsustainable in some countries even prior to the pandemic. This difficult context may be one reason why the scale of discretionary tax and spending policy measures undertaken in response to the pandemic has generally been much smaller than in high-income countries.

This report begins by setting out trends and forecasts for budget deficits, debts and debt-servicing costs in SSA. A number of countries with the largest economies that have debt-servicing costs that take up a very high share of revenues, most notably Ghana and Nigeria, are seeing these costs rise even further. Well-designed fiscal consolidation measures, such as discretionary tax increases and/or spending cuts, should therefore be considered to improve the sustainability of the public finances of a number of countries.

Doing so would help address some of the costs that can arise from high deficits, debts and debt-servicing costs, including the potential crowding out of investment, increased vulnerability to – and reduced ability to respond to – economic shocks, constraints on monetary policy, all of which could ultimately lead to slower economic growth over the longer term. However, fiscal consolidation measures are not costless; higher taxes and/or lower public spending can also have negative effects on the economy in the short and longer term. A successful fiscal consolidation will minimise these costs, with implications for the timing and composition of measures undertaken. In particular, empirical research finds that the negative effects of tax rises and spending cuts are larger when the economy is already weak, suggesting that, if possible, fiscal consolidation should commence once economies have significantly recovered from the COVID-19 crisis. Where the fiscal situation requires more immediate action, it may be useful to distinguish

between two phases of the consolidation: immediate measures, which can be implemented relatively quickly and which minimise short-term negative effects on the economy; and longer-term measures, which may take time to design and implement but both help directly reduce budget deficits and improve the efficiency of public spending and the tax system.

It is beyond the scope of this report to give specific recommendations for specific countries. However, given that it is likely that many countries in SSA will need to increase public spending overall in order to improve public services, to scale up social protection systems and to invest in infrastructure, increases in tax revenues will likely take much of the weight of fiscal consolidation efforts. In some countries though, there may be scope to rationalise certain expenditures, including subsidies to consumers and state-owned enterprises and overly large public sector payrolls.

### Key findings

- 1 Between 2013 and 2019, gross public debt increased from an average of 30% to 47% of GDP for the 24 low-income countries in SSA tracked by the IMF's April 2021 Fiscal Monitor report. An increased reliance on private non-concessional debt saw debt-servicing costs increase even more, from an average of 8.1% to 16.1% of government revenues.
- 2 These increased debts and debt-servicing costs may have constrained the fiscal responses of countries in SSA to the COVID-19 pandemic. Discretionary tax cuts and spending increases have typically been modest, which helps explain a much smaller increase in budget deficits than in high-income countries: an estimated average of 5.7% of GDP in 2020, up from 4.3% of GDP in 2019. Across the region as a whole, therefore, while debt is forecast to have spiked at 53% of GDP in 2020, it is forecast to fall back to 49% of GDP by 2026 – although debt-servicing costs are forecast to increase further to 22.5% of revenues by the same date.
- 3 The picture differs significantly across countries though. For example, the debt-to-GDP ratio is forecast to increase in half and decrease in half of the 24 countries tracked by the IMF. Ghana and Nigeria stand out as facing particularly challenging circumstances. Ghana's debt-to-

GDP ratio is forecast to increase from 63% to 85% between 2019 and 2026, with debt-servicing costs amounting to over 50% of revenues every year. In Nigeria, while debt levels are relatively low and forecast to increase only modestly, low revenues mean debt interest costs are forecast to amount to 37% of revenues by 2026, up from 21% in 2019. Fiscal consolidation measures therefore seem worthy of serious consideration in these countries. The four other largest economies (Cote d'Ivoire, Ethiopia, Kenya, and Tanzania) are also forecast to have debt-servicing costs exceeding 10% of revenues in 2026, and these countries may also wish to consider fiscal consolidation measures.

- 4 A successful fiscal consolidation will improve the sustainability of public finances by lowering the trajectory for debt and debt-servicing costs while minimising any negative effects on the economy. Research suggests that achieving this can help address several issues that arise when debt and debt-servicing costs are high and/or rising. These include: the crowding out of investment by the private sector; increased vulnerability to a range of economic shocks (e.g. to interest rates, exchange rates and output); reduced ability to respond to economic and other shocks via discretionary fiscal policy measures; constraints on monetary policy, especially when debts are foreign-currency-denominated; the increased risk of default; and, ultimately, lower economic growth.
- 5 Key considerations for consolidation include the timing and composition of the measures. Both should take account of economic conditions. Where possible, consolidation should not take place while an economy is still weak – and particularly so if monetary policy is constrained – as the short-term demand and longer-term scarring effects are likely to be greater at these times. When more immediate action is required during a time of economic weakness, consideration should be given to measures that are less likely to depress demand. This includes increases in taxes on personal income – especially for those with high incomes – and corporate income, which could be made temporary to limit negative effects on investment. One-off wealth or windfall taxes could also be efficient, although, if there is a



perception that such taxes will be repeated or made permanent, they will risk depressing and distorting investment.

- 6 It may take time to design, plan and implement measures that are more suitable for longer-term fiscal consolidation. Given that it is likely that most low-income countries in SSA will need to increase overall public expenditure to meet development goals, increases in tax revenues are likely to be key. Introduction and expansion of 'green' taxes and property taxes, and rationalisation of tax expenditures – including widespread exemptions and reduced rates of value-added tax – could both raise revenue and increase the efficiency of the tax system. Empirical research also suggests that a range of administrative reforms and enforcement activities can yield worthwhile revenues.

# 1. Introduction

Since Spring 2020, the COVID-19 pandemic has put significant pressure on the public finances of both developed and developing countries. On the revenue side of the budget, a decline in international trade volumes and falls in commodity prices in 2020 negatively affected customs and natural resource revenues. Social distancing and lockdown measures that have been introduced to help contain the pandemic have further disrupted economic activity, with knock-on effects for revenues from domestic taxes and social security contributions. Governments have also provided support to businesses and households through both the tax and social protection systems, and have seen the cost of providing many public services, notably healthcare, rise as a result of increased demand and a need for infection control measures. Such policies, while providing much needed support to the population and public services, and potentially helping avoid even greater long-term damage to the economy, have added to the short-term fiscal costs of the pandemic.

These fiscal deficits and the resulting debt are a particular challenge for countries in sub-Saharan Africa (SSA), many of which have ambitious targets to raise revenues to fund increased investment in public services, social protection systems and infrastructure. A number of countries in the region already had deficits and debts that looked unsustainable prior to the pandemic – situations that the additional borrowing will have exacerbated, and that prevented governments from offering more fiscal support to their economies and public services. In addition, limited vaccine availability and new more contagious variants of COVID-19 mean that countries in the region could face further surges in cases, necessitating the reimposition of lockdown measures, and potentially delaying economic recovery and reductions in budget deficits. Indeed, as of late June 2021, countries including the Democratic Republic of the Congo (DRC), South Africa, Uganda, Zambia and Zimbabwe are in the midst of major surges in cases, with signs of increases in a range of other countries, especially in the south and east of the continent.

Countries in SSA therefore face a tricky set of trade-offs when it comes to fiscal policy. On the one hand, continuing economic weakness and the possibility of having to reintroduce lockdown measures mean that in some cases fiscal support

and fiscal stimulus measures may be called for. On the other hand, precarious fiscal situations mean that the need to reduce budget deficits and debts cannot be postponed indefinitely. Given a push to increase social spending in order to help meet the Sustainable Development Goals, this will likely mean increases in taxation, rather than reductions in spending – although subsidy reform may also play a role in some countries.

Previous TaxDev reports have set out the principles of and options for fiscal support (Steel and Phillips, 2020) and fiscal stimulus (Steel and Harris, 2020) for low- and middle-income countries. This report instead focuses on the principles of and options for fiscal consolidation: that is, measures that reduce budget deficits and improve debt sustainability.

In Chapter 2, we start by laying out the fiscal context of SSA. We show that many countries in the region faced the pandemic with limited fiscal space and that, partly as a consequence, they implemented fewer discretionary tax and spending measures to counteract the pandemic and the associated economic crisis. This means that their budget deficits and debt have generally increased by less than in high-income countries. Nevertheless, many countries in the region face high debt-servicing costs and debt sustainability issues, and a number may need to consider significant fiscal consolidation measures going forward.

Chapter 3 sets out the rationales for undertaking fiscal consolidation and the economic principles governing the design of consolidation policies. While fiscal consolidation is complex and often politically difficult, we find that there are a number of economic rationales for closing the fiscal gaps diagnosed in Chapter 2. These largely coincide with reasons for countries to run their public finances in a sustainable way, but are made more acute by the current large fiscal imbalances in a number of countries. A well-designed consolidation minimises contractionary effects during the adjustment and accounts for equity and wider developmental concerns, while being large enough to meaningfully improve a country's public finance position. Key considerations include the timing and composition of the fiscal consolidation measures.

In Chapter 4, we explore specific policy options for countries in SSA – which are relevant for a wider group of countries seeking to raise revenues to fund increased public expenditure. The policies explored include temporary increases to personal and corporate income taxes and wealth levies, and potentially more permanent

increases in property taxes and ‘green’ taxes, and reforms to the exemptions and reduced rates of value-added tax, as well as other tax expenditures. Administrative measures that have been shown to increase tax revenues are also discussed.

Chapter 5 provides our concluding thoughts.

From the start, it is important to recognise that this report is not the first to consider either the fiscal outlook for SSA, or the broad options for revenue-raising post-pandemic. Our analysis of the fiscal context, for example, draws heavily on forecasts that the International Monetary Fund (IMF) set out in its April 2021 Fiscal Monitor report (IMF, 2021a). And studies by researchers at the International Growth Centre and Centre for Global Development have also considered options for revenue-raising post-pandemic.<sup>1</sup> We see the role of this report as considering both the fiscal situation and revenue-raising options together and, in particular, identifying revenue-raising options that are consistent with the principles of fiscal consolidation. In doing so, it builds on recent guidance provided to TaxDev partner countries as they seek to boost domestic resource mobilisation and to improve their fiscal positions.

<sup>1</sup> See Harmon et al. (2021) and Mullins et al. (2020).

## 2. The fiscal context and outlook

The COVID-19 pandemic has had a significant impact on the economies and public finances of countries across SSA. Real GDP for the region declined by 1.9% in 2020, compared to a pre-pandemic forecast of growth of 3.6% (IMF, 2019a, b, 2021b). While this was a smaller fall than in advanced economies, the recovery is also expected to be slower, in part reflecting the limited vaccine availability and the greater risk of resurgences in disease spread, and hence the need for lockdown measures. Thus, while GDP is expected to be 2.5% lower in 2024 than pre-pandemic forecasts in high-income countries, in SSA it is expected to be 6.0% lower.

Economic contraction and slow recovery have depressed and will continue to depress government revenues across the region. This has pushed up budget deficits and debt across the region, despite the relatively modest discretionary tax and spending measures introduced – which the IMF has characterised as being constrained by limited policy space (IMF, 2021a). These constraints reflect the fact that whilst countries have been able to access emergency IMF and World Bank funding, the amounts available have been limited, and many countries in the region face high credit costs when issuing debt on the private market.

In this chapter, we set out the fiscal context for SSA, focusing on several key metrics.

- The *overall budget balance*, which is the difference between public sector revenues and expenditures. Positive values represent budget surpluses, while negative values represent budget deficits. To aid comparability across countries with economies of very different sizes, we use figures expressed as a percentage of GDP.
- *Gross public sector debt*, measured as a percentage of GDP, and in some instances as a percentage of public sector revenues.

- *Debt-servicing costs*, which is the amount required to pay interest on accumulated public sector debt. These costs are expressed as a percentage of public sector revenues.

We also discuss the extent to which measures to reduce deficits, debts and debt-servicing costs (i.e. fiscal consolidation measures) may be needed.

## 2.1. The IMF's fiscal forecasts

In its April 2021 Fiscal Monitor, the IMF includes outturns and forecasts, by country, for public sector revenue and expenditure, as well as fiscal balances and gross debt. Debt servicing costs can be calculated from this data as the difference between the primary and overall fiscal balance of a country. Figure 2.1 shows the average for each of these indicators for 2019, 2020, 2021 and 2026 for high-income, middle-income and those low-income countries that are in SSA, weighted using countries' GDP.<sup>2</sup>

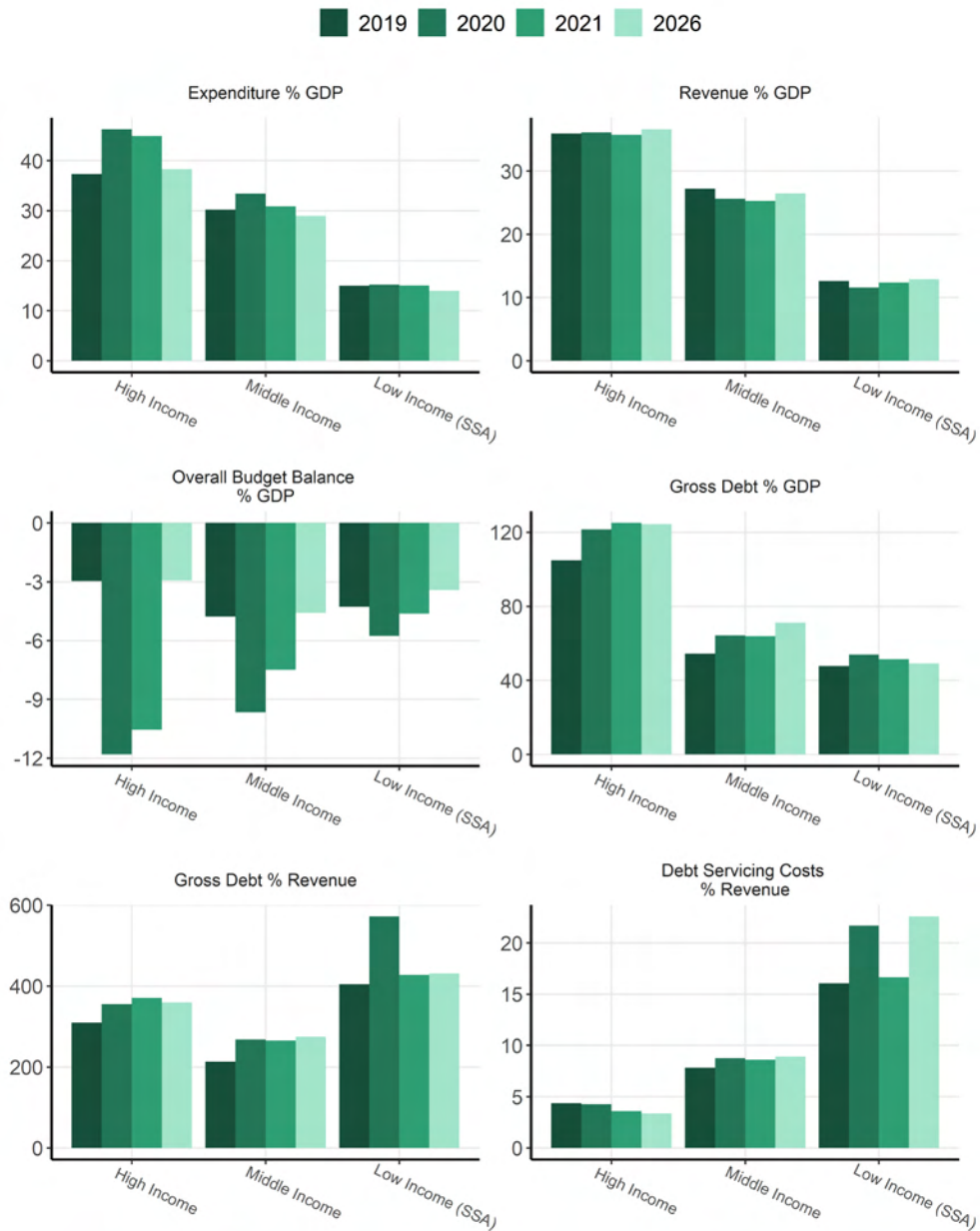
The first thing that stands out is the very different changes in public expenditure as a percentage of GDP in response to the COVID-19 pandemic. Public expenditure increased by almost 9 percentage points of GDP (from 37.3% in 2019 to 46.0% in 2020) in high-income countries, with most of this driven by discretionary increases in expenditure to address the pandemic rather than the fall in GDP. In contrast, public expenditure increased by just 3.2% of GDP in middle-income countries, and by just 0.2% of GDP in low-income countries in SSA. This illustrates the constraints that countries in the region faced in implementing a fiscal response to the pandemic.

Because of this, while low-income countries in SSA saw a larger fall in revenues (of 1.0% of GDP) than high-income countries (where the decline in revenue was broadly in line with GDP), the average deterioration in fiscal balance was relatively modest. For example, budget deficits rose from an average of 4.3% of GDP in 2019 to a forecast 5.8% in 2020, compared to an increase from 3.0% to 11.8% in high-income countries. As a result, increases in gross debt have also been relatively

<sup>2</sup> In Figure 2.1 and the remainder of this section, we use the IMF's income classifications rather than the World Bank's. The IMF records all countries in SSA, with the exception of Angola and South Africa, as low-income countries.

modest as a percentage of GDP – although the fall in revenues means that gross debt did notably spike relative to revenues last year.

**Figure 2.1. Key fiscal indicators for high-, middle- and low-income countries in SSA**



Note: Debt-servicing costs are calculated as the difference between the overall budget balance and the primary budget balance. High-income, middle-income and low-income (SSA) means are calculated using 2019 GDP weights.

Source: IMF (2021a).

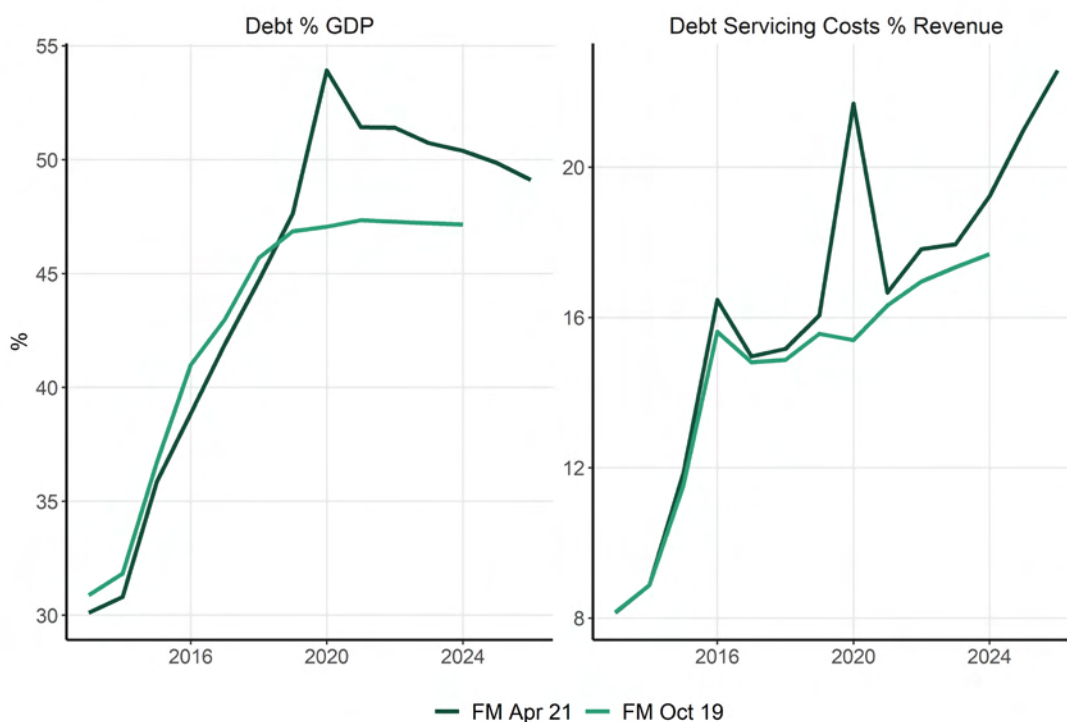
The IMF forecasts a recovery in revenues and a fall in budget deficits among low-income countries in SSA this year, with deficits averaging 4.6% of GDP, just a little higher than in 2019. Whether this turns out to be true though will depend very much on the course of the pandemic and the public health restrictions in place in the region. Looking to the future, the IMF forecasts a further decline in budget deficits, to an average of 3.4% of GDP by 2026 – less than pre-pandemic levels. As a result, gross public sector debt is forecast to average 49% of GDP in 2026, only a little higher than the 47% prevailing in 2019. In contrast, among high-income countries, debt is forecast to be 124% of GDP in 2026, up from 104% in 2019.

Despite the relatively modest increases in borrowing and debt in low-income countries in SSA, the final panel of Figure 2.1 shows that the cost of servicing debt interest spiked in 2020 and is forecast to rise again over the next few years. For example, while debt interest costs amounted to an average of 16% of revenues in 2019, they spiked at 21.7% of revenues in 2020 (partly due to a fall in revenues) and, after falling back, are set to increase again over the next few years to an average of 22.5% of revenues in 2026. This is in stark contrast to high-income countries where, despite a much larger increase in debt levels, the cost of servicing debt interest is forecast to fall to an average of just 3.4% of revenues in 2026.

Figure 2.2 shows that an increase in debt-servicing costs was forecast pre-pandemic; the pandemic has therefore exacerbated an already problematic trend. Indeed, the years preceding the pandemic saw a large increase in both debt and debt-servicing costs for low-income countries in SSA. Gross debt increased from an average of 30% of GDP in 2013 to 47% in 2019, while debt-servicing costs approximately doubled as a share of revenues, from 8.1% to 16.1% of GDP between 2013 and 2019, squeezing the revenues available for spending on public services, social protection and infrastructure investment.



**Figure 2.2. Forecasts for debt (as percentage of GDP) and debt-servicing costs (as percentage of revenue), for low-income countries in SSA, pre- and post-pandemic**



Note: Debt-servicing costs are calculated as the difference between the overall budget balance and the primary budget balance. The mean for low-income countries in SSA is calculated using GDP weights. Values before 2019 may differ due to revisions.

Source: IMF (2019a, 2021a).

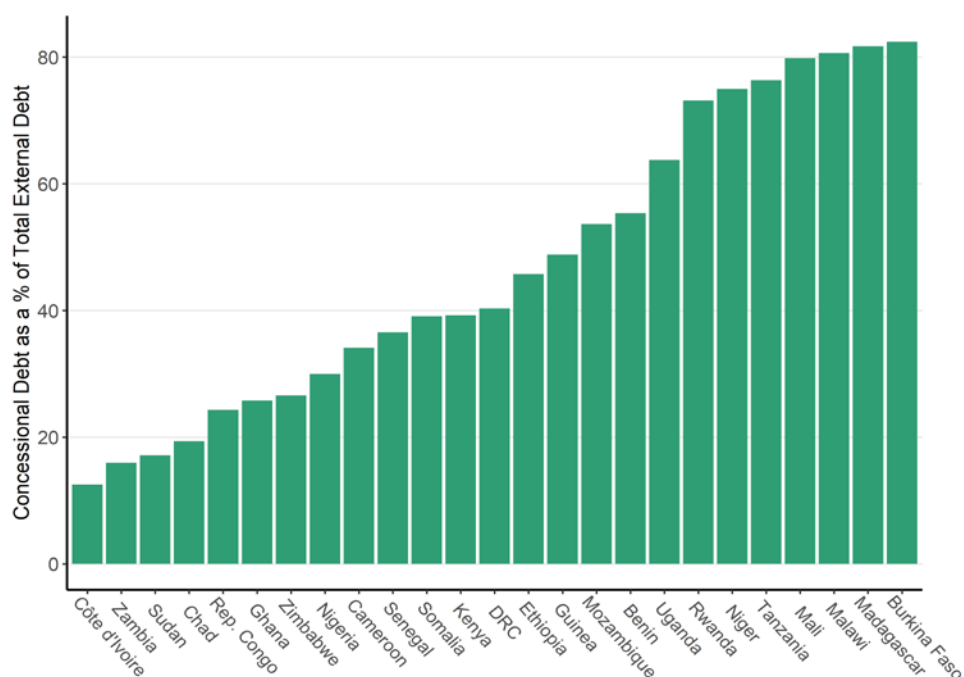
It is worth noting that these GDP-weighted averages are significantly affected by trends in countries with larger economies, such as Nigeria and Ghana. Trends in simple unweighted average debt and debt-servicing costs – which weight all countries equally – show similar trends in debt and debt-servicing costs pre-pandemic, with average debt increasing from 34% to 59% and debt-servicing costs increasing from 5.9% to 11.4% between 2013 and 2019. But the forecasts in unweighted average debt and debt-servicing costs look less bad over the next few years – reflecting the fact that further increases in debt and debt-servicing costs are forecast to be concentrated in the region’s larger economies. Related to this, a significant proportion of the debt of many of the smaller, poorer economies in the region is concessional debt, provided at below-market interest rates by other countries or international bodies. Box 2.1 discusses this issue in more detail.

### Box 2.1. Concessional debt in SSA

Concessional debt refers to debt that has significantly better terms than market debt, such as longer grace periods or lower than market-level interest rates. This debt is typically funded by loans from the governments of high-income countries, or multilaterally via the IMF, World Bank or other development banks.

Figure 2.3 shows the fraction of the external debt of a range of countries in SSA (i.e. debt that is owed to individuals or organisations outside the country in question) that is concessional.

**Figure 2.3. Concessional debt as a percentage of total external debt in 2019**



Note: Concessional debt refers to multilateral concessional debt and bilateral concessional debt.

Source: World Bank.

The figure shows significant variation in the share of external debt that was concessional in 2019, from less than 20% in Cote d'Ivoire, Zambia, Sudan and Chad, to over 80% in Mali, Malawi, Madagascar and Burkina Faso. On the one hand, countries reliant on concessional debt could be particularly vulnerable if the supply of concessional financing is reduced, or demand for such financing increases. However, on the other, those countries that rely mostly on private financing, including relatively large economies such as Ghana and

Nigeria, typically pay higher interest rates on their debt and are more exposed to changes in market interest rates, and they are likely to benefit less from donor-led debt forgiveness initiatives.

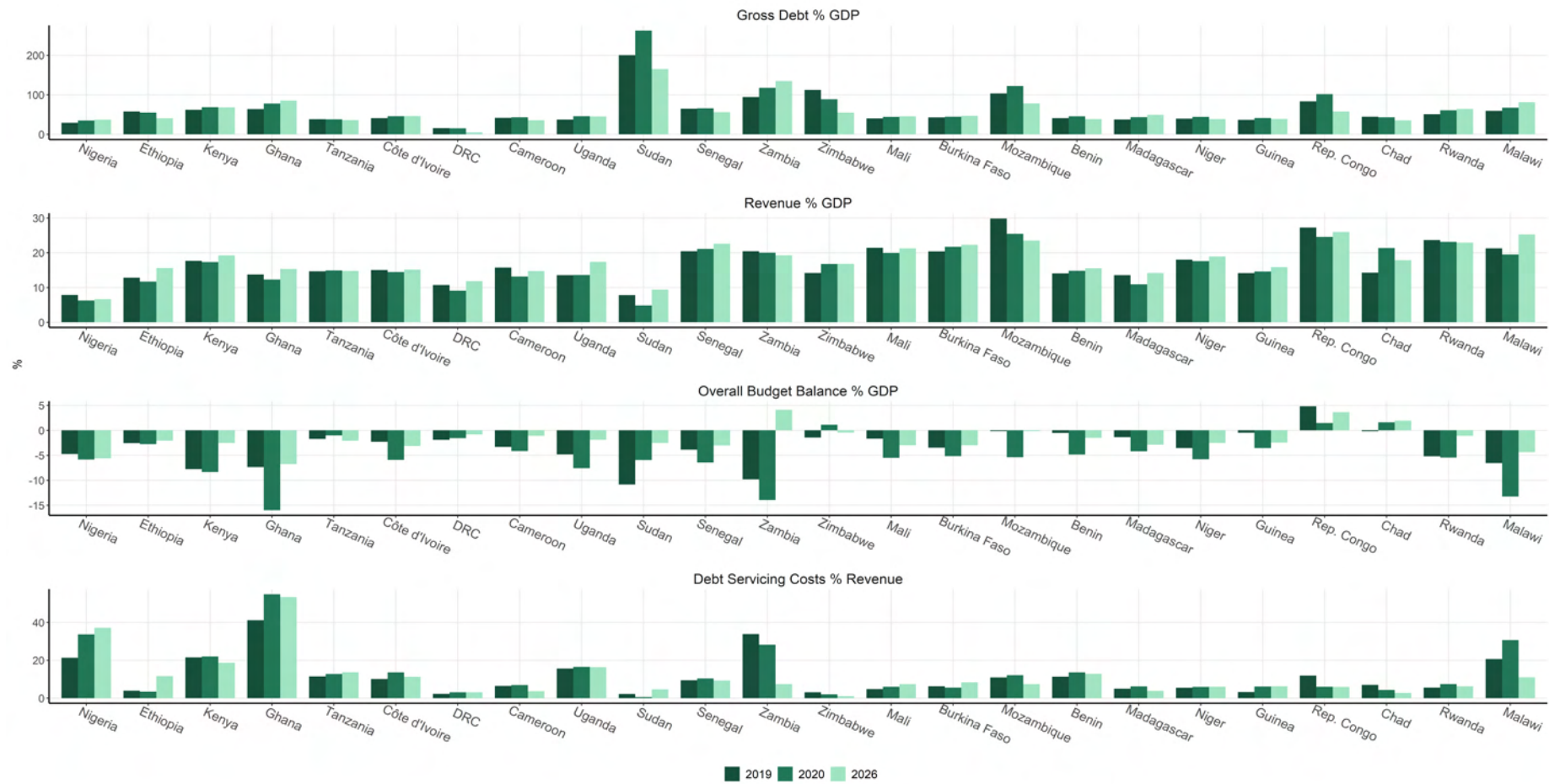
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Figure 2.4 shows outturns and forecasts for revenue, fiscal balances, debt and debt-servicing costs separately for all low-income countries in SSA for which IMF data are available, illustrating the diversity of trends across the region.

For example, while 19 out of the 24 featured countries are estimated to have seen an increase in debt-to-GDP ratios between 2019 and 2020, the scale of increase varies significantly: less than 2 percentage points (pp) in Burkina Faso, Cameroon and Senegal; to 14pp in Ghana, 18pp in the Republic of Congo, 19pp in Mozambique, 23pp in Zambia and a reported 62pp in Sudan.

Looking to the future, between 2019 and 2026, the debt-to-GDP ratio is forecast to increase in only 12 out of the 24 countries, and to decline in the other 12. Some of these declines are relatively small, such as in Niger (1pp), Tanzania (2pp) and Benin (3pp). But in others, the decline is expected to be substantial, including Mozambique (25pp) and Republic of Congo (25pp) – in both cases, a big turnaround from the picture in 2020 – and also Sudan (35pp) and Zimbabwe (57pp). However, a number of countries are forecast to see a large increase in their debt-to-GDP ratios, including Ghana (22pp, to 85%), Malawi (22pp, to 81%) and Zambia (40pp to 135%).

Figure 2.4. Fiscal indicators for low-income countries in SSA, for 2019, 2020 and 2026 (forecast)



Note: Debt-servicing costs are calculated as the difference between the overall budget balance and the primary budget balance.

Source: IMF (2021a).

Different trends in fiscal balances – as well as in GDP – underlie these different debt trajectories. For example, Ghana’s budget deficit is estimated to have increased from 7.3% of GDP in 2019 to 16% in 2020, and is forecast to slowly decline to 6.8% of GDP by 2026, driving its debt up. In contrast, the Republic of Congo is expected to run a budget surplus each year, helping explain the medium-term fall in its debt-to-GDP ratio (the short-term spike in its debt-to-GDP ratio reflects a large fall in GDP linked to declines in oil prices in 2020). Overall, 19 out of 24 countries are estimated to have seen an increase in their budget deficit in 2020 compared with 2019. But by 2026, budget deficits are forecast to be lower than 2019 levels in 15 out of the 24 countries included in the IMF’s data.

Differences in the levels and trends in debt-servicing costs reflect both differences in the levels and trends in debt, and in debt interest rates. The latter can be particularly affected by increases or decreases in the share of debt that is subject to concessional terms, as well as debt restructuring.

Zambia, for example, is forecast to have the largest increase in debt-to-GDP ratio in SSA between 2019 and 2026, but to see a large fall in debt-servicing costs (from 34% of revenues in 2019 to just 7.5% of revenues in 2026), following its technical default and request for debt relief and an IMF restructuring programme.<sup>3</sup> Malawi is also forecast to see a fall in debt-servicing costs after a spike in 2020 – from 20.7% of revenues in 2019, to 11% of revenues in 2026 – despite its increased debt burden, potentially reflecting its use of concessional debt (one of the highest in SSA).

However, debt-servicing costs are high and increasing in those countries that are largely reliant on expensive non-concessional debt – notably, Ghana and Nigeria. Ghana’s debt interest bill was already over 40% of revenues in 2019. The aforementioned significant increase in borrowing and debt as a result of the pandemic, driven in part by Ghana’s relatively substantial fiscal response to the COVID-19 pandemic – for example, via tax waivers and increased health spending<sup>4</sup> as well as recession-induced falls in revenue, is forecast to have increased debt interest to 55% of revenues last year. Looking to the future, debt interest costs are set to reach 63% of revenues by 2022, and still be over 53% by 2026. In the case of

<sup>3</sup> Source: <https://www.reuters.com/article/imf-zambia-idUSL1N2MX1J1>.

<sup>4</sup> AFRODAD (2020).

Nigeria, while its gross debt is relatively modest – 29% of GDP in 2019, 35% last year and a forecast of 37% in 2026 – and its budget deficit forecast is relatively stable at between 4% and 6% of GDP, high and increasing interest rates and low revenues mean that debt interest is forecast to account for 37% of revenues by 2026, up from 21% in 2019.

These two countries may therefore consider some degree of fiscal consolidation in order to put their public finances on a sounder footing, to reduce debt-servicing costs to more manageable levels, and to finance other government spending. In addition, Kenya (19%), Uganda (16%), Tanzania (14%), Benin (13%), Ethiopia (12%) and Côte d'Ivoire (11%) are all projected to have ratios of debt-servicing costs to revenues above 10% in 2026. Increases in revenue would immediately reduce these ratios and, if not all immediately spent, would help to reduce debt levels faster, creating additional fiscal space in subsequent years; it is worth noting though that among these countries, it is only Ethiopia where forecasts are for a clear trend of increasing debt-servicing costs. It is also notable that the six largest countries in the region – Nigeria, Ethiopia, Kenya, Ghana, Tanzania and Côte d'Ivoire, in order of size – are among the group of countries with high or very high debt-servicing costs. Any fiscal crisis in one of these countries – and especially Nigeria – may be more likely to have wider regional repercussions than a crisis in one of the smaller economies such as Malawi or Zambia, which are set to benefit from substantially lower debt-servicing costs.

These fiscal trajectories do of course partly hinge on developments in the international debt landscape. The Debt Service Suspension Initiative (DSSI) was recently extended until the end of 2021, suspending (but not providing relief on) debt servicing payments to official bilateral creditors for eligible countries. Thus far, 31 countries in SSA have signed on to the initiative, which delivered over \$5 billion in relief in 2020 – although private and multilateral development bank debt payments are excluded. The G20 Common Framework for Debt Treatment beyond the DSSI may provide another mechanism for debt restructuring or deferral on a broader basis, and Chad, Ethiopia and Zambia have already made requests for treatment under this framework.<sup>5</sup> The allocation of \$650 billion of special drawing

<sup>5</sup> See the IMF's questions and answers on sovereign debt issues at <https://www.imf.org/en/About/FAQ/sovereign-debt>.

rights (SDRs) from the IMF means that countries in SSA will receive a roughly \$23 billion boost to their reserves; the bigger impact though may come from any donation or lending of these SDRs out of the quotas received by high-income countries.<sup>6</sup> Linked to this, the recently announced Liquidity and Sustainability Facility (LSF) may provide an outlet for some governments to lower borrowing costs.<sup>7</sup> And the announcement of an early replenishment of the World Bank's International Development Association (IDA) – the largest source of concessional loans and grant finance for the world's poorest countries – provides another channel for cheaper finance for eligible countries in SSA.<sup>8</sup> Initiatives such as these will provide welcome liquidity for many countries, while allowing them to reduce the cost of servicing debt. However, absent large-scale debt relief efforts, these measures will largely provide temporary respite, delaying but not eliminating the need for fiscal consolidation efforts.

## 2.2. Summary

Many countries – including a number of those with the largest economies – in SSA entered the COVID-19 pandemic in a difficult fiscal position. Debt and debt-servicing costs increased substantially during the 2010s, with the latter forecast to continue to increase for the region as a whole even prior to the pandemic.

Delving deeper though, trends in borrowing, debt and debt-servicing costs vary significantly across countries. Ghana and Nigeria in particular stand out as facing very high debt-servicing costs relative to their revenues, with Ghana also facing high and substantially increasing debt levels. While it is beyond the scope of this report to determine the necessity or desirability of fiscal consolidation measures in each country – let alone to consider possible magnitudes – it seems highly likely that these countries will have to consider raising revenues to consolidate their public finances, as well as to fund additional public expenditure to meet their development goals.

A broader range of countries face debt-servicing costs that amount to more than 10% of revenues, with Ethiopia in particular forecast to see its ratio of debt-

<sup>6</sup> See Andrews, Hicklin and Plant (2021).

<sup>7</sup> Source: Economic Commission for Africa website, <https://www.uneca.org/stories/eca-launches-lsf%2C-a-vehicle-for-debt-management-and-fiscal-sustainability>.

<sup>8</sup> See Landers (2021).

servicing costs to revenues roughly triple (to 12%) by 2026 as it increasingly relies on more expensive private borrowing. Fiscal consolidation measures could also be considered by these countries, especially if they want greater fiscal space to respond to future crises.

Even those countries already forecast to see substantial improvements in their deficits and debt-servicing costs may wish to consider further revenue-raising measures. For example, while Zambia's debt-servicing costs are forecast to decline significantly and its budget to be in surplus by 2026, its debt levels will still be high, and the entire fiscal adjustment forecast will take the form of spending cuts rather than revenue increases.

All the forecasts summarised in this section are highly uncertain. Economic forecasts are always uncertain, but the dependence of economic recovery on successful management of the pandemic regionally and globally, including the availability of vaccines, only heightens this. Developments in the international debt landscape could also have important implications for the fiscal context in SSA. Nonetheless, it is clear that the outlook is challenging. Indeed, six countries in the region are already in debt distress, with a further 16 judged to be at a high risk.<sup>9</sup> In this context, fiscal consolidation efforts are not just a theoretical consideration: South Africa's 2020 Medium Term Budget Policy Statement set out plans for fiscal consolidation in the coming years (National Treasury, 2020) and Kenya's medium-term forecasts assume a closing fiscal deficit due to fiscal consolidation efforts (World Bank, 2021). This makes it important to carefully consider the rationales behind such approaches, as well as where some of the opportunities lie for policy.

The next chapter therefore sets out the rationale for fiscal consolidation when public finances are unsustainable, and the principles for implementing effective fiscal consolidations. Chapter 4 sets out some particular suggestions for countries in SSA.

<sup>9</sup> Source: the IMF's list of LIC DSAs for PRGT-eligible countries (as of 30 April 2021), <https://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf>. Debt distress occurs when a country is already facing difficulties servicing its external debt; a high risk indicates that under baseline assumptions, one or more external debt burden thresholds from an IMF–World Bank debt sustainability analysis is likely to be breached. For more information, see <https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/39/Debt-Sustainability-Framework-for-Low-Income-Countries>.



## 3. The principles of fiscal consolidation

In this chapter, we discuss the potential benefits of fiscal consolidation – including the risks associated with not tackling unsustainable public finances – and the principles for implementing successful fiscal consolidation.

### 3.1. Rationales for fiscal consolidation

Fiscal consolidation – the enacting of discretionary tax rises and/or spending cuts to improve a country’s public finances – is economically and politically painful. Therefore, it is important to understand why governments may need to implement consolidation measures and what the potential benefits are.

At a high level, fiscal consolidation is needed when a country’s public finance position is – or is at risk of – becoming unsustainable, and represents a significant restriction on a country’s ability to respond to economic and fiscal shocks. Thus, the rationales for fiscal consolidation are often closely related to the reasons why governments should pay attention to the sustainability of their public finances in general.

#### ‘Crowding out’ of investment

When the supply of funds that can be loaned and borrowed is relatively inelastic – as may be the case domestically in low-income countries – high levels of government borrowing can increase the price of funds. This increases the cost of external capital to the private sector, potentially depressing private investment, which is said to be ‘crowded out’. This lower investment could in turn feed into lower productivity and economic growth.

It is empirically challenging to establish ‘crowding out’ because government borrowing and private investment are both driven by the economic cycle. With government borrowing rising and private investment falling in economic

downturns, for example, there would be a negative correlation between public borrowing and private investment even if there was no causal relationship between the two. To overcome this problem, Huang, Panizza and Varghese (2018) examine how public debt levels affect investment by industries according to their reliance on external finance (as opposed to retained profits) and their levels of cash flow. On the one hand, they find that new, small and unlisted firms, which are reliant on external finance, cut back their investment relative to firms that can utilise retained profits when government debt is higher. On the other hand, they find no effect of public debt levels on investment by larger listed firms.

Vanlaer, Picarelli and Marneffe (2021) use data from the European Union (EU) and find that higher public – but not private – debt depresses private sector investment, with each 10 percentage point increase in debt reducing private investment by 1.4% in the short term and by 0.23% in the long term. However, they find little evidence of these effects being greater when general credit conditions are tighter, although they do find that countries that are more financially open have less of a relationship between public debt and private investment. This makes sense as the supply of funds to both the public and private sectors is likely to be more elastic in more financially open countries.

There is also evidence from the EU that high levels of public debt and borrowing are associated with reduced *public* investment. Picarelli, Vanlaer and Marneffe (2019) find that each 10% increase in public debt reduces public investment by 0.3%, with the effect driven by high-debt countries, suggesting that impacts are increasing with debt levels.

### Increased vulnerability to shocks

High levels of borrowing, debt and debt-servicing costs can make a country's public finances more vulnerable to economic shocks, and constrain its ability to effectively respond to those shocks.

For example, the higher a country's debt and debt-servicing costs, the more exposed its public finances are to changes in interest rates. In particular, increases in interest rates, whether due to external factors or as part of domestic monetary policy, would further increase debt-servicing costs. If monetary policy is not set independently, this could create a bias towards expansionary monetary policy, contributing to higher inflation.

Related to this, high debt and debt-servicing costs are also likely to make countries more vulnerable to negative shocks to investor confidence. Times of economic uncertainty are associated with a ‘flight to safety’, pushing up the cost of government debt in low- and middle-income countries, even as the cost falls in high-income countries – a phenomenon seen during the early phase of the COVID-19 pandemic.

In addition, falls in revenues are also more likely to be problematic, as continuing to meet debt-servicing costs would require bigger cuts to other areas of government spending, especially if high levels of debt and debt-servicing costs make further borrowing difficult. This ‘debt overhang’ means that, more generally, governments may have less scope to borrow to respond to crises. For example, countercyclical fiscal policy (i.e. increases in spending and reductions in taxes during recessions, and vice versa during expansions) can help smooth economic cycles, and lessen the long-term negative effects of downturns on the economy. However, while the evidence is that high-income countries pursue such policies, low-income countries – especially those in SSA, and those reliant on natural resources – are found to have a bias towards pro-cyclical fiscal policy (Herrera, Kouame and Mandon, 2019). A range of factors – including weak budgeting frameworks and political institutions – can explain this, although the evidence for high levels of debt playing a role is mixed; Herrera et al. (2019) find no relationship while Frankel, Vegh and Vuletin (2013) do find a relationship.

As discussed in the previous chapter, it is also notable that with some exceptions (such as Ghana) the discretionary fiscal responses of African countries to the COVID-19 pandemic have been relatively limited. Again, while a range of factors – including the administrative difficulties of channelling funds to businesses and households – have contributed to this response, limited fiscal space may also play a role (IMF, 2021a).

### Constraints on monetary policy

Many countries sell a significant proportion of their debt to individuals and institutions based overseas, with countries in SSA often selling debt denominated in a currency (typically the US dollar) other than their own. External liabilities, and especially foreign-currency-denominated debt liabilities, create challenges for foreign exchange management and make the country vulnerable to exchange rate

fluctuations. This in turn limits the space for using monetary policy as part of domestic demand management.

In order to service foreign-currency-denominated debt, a country needs to hold adequate foreign exchange reserves or to be able to buy foreign exchange in order to make good on its obligations. This means that it must manage its reserves more conservatively than it would otherwise find optimal. And, to the extent that there is a continuous need for foreign exchange, this also creates costs and risks from exchange rate fluctuations.

External debt may also limit the ability of a country's central bank to use monetary policy interventions to stabilise output. This is because if obligations must be met through foreign exchange, then if the country's currency becomes weaker, financing debt obligations becomes costlier. But if the central bank needs to be more concerned about the exchange rate, it has less ability to stimulate its own economy through lower interest rates.

### Slower economic growth

There is strong evidence that high levels of government debt are negatively associated with economic growth. This could arise through the crowding out of private sector investment discussed above, through expectations of future fiscal adjustments via tax increases and spending costs, through increased uncertainty and reduced confidence as a result of the risk of a default and financial crisis, and through the constraints imposed on government fiscal policy and investment by limited fiscal space.

An influential paper by Reinhart and Rogoff (2010), using data for 20 high-income countries over 60 years, argued that economic growth was significantly lower once public debt exceeded 90% of GDP. Subsequent papers have questioned the existence of such a discrete threshold (e.g. Chudik et al., 2017), but confirm the negative correlation between past debt levels and future economic growth. However, as with the relationship between debt and investment, it is difficult to disentangle causality from correlation caused by other factors driving both debt and growth outcomes, such as the quality of institutions (Fatas et al., 2019). Indeed, Kourtellos, Stengos and Tan (2013) find that only for countries characterised by poor institutions – a situation that includes many countries in SSA – is there a relationship between debt and subsequent economic growth. As countries with poor

institutions also generally have higher debt levels, this could also drive the more general negative correlation between debt and growth.

### The consequences of default

Ultimately, if debt and debt-servicing costs become too great, it may become desirable or necessary to default on debt. Default, and the restructuring of debt, can allow a country to lower its debt-servicing costs, freeing up tax revenues for more productive purposes. However, defaults and debt restructuring are not costless, with Borensztein and Panizza (2008) identifying four types of costs: reputational costs; international trade exclusion costs, financially mediated costs; and political costs to the authorities. They find that each year of default is associated with growth that is lower by 1.2 percentage points, with this effect being concentrated in the first year of default (2.6 percentage points). This leads them to conclude that the effect is ‘significant but short-lived’.

It is not the case that countries that have defaulted find themselves locked out of international credit markets for a substantial period of time; for example, Gelos, Sahay and Sandleris (2011) find that countries that defaulted in the 1980s were able to borrow again after an average of four years. There is evidence that countries that have defaulted are awarded lower credit ratings – which might be expected to push up borrowing costs – after controlling for other factors (Cantor and Packer, 1996; Reinhart, Rogoff and Savastano, 2003). However, the evidence of impacts of default on borrowing costs suggests that the effects, while large, abate after a few years (Borensztein and Panizza, 2008).

Evidence suggests that defaults are associated with declines in international trade, although it is unclear whether these effects are long-lasting or short-term; for example, Rose (2005) finds effects lasting up to 15 years, whereas Borensztein and Panizza (2008) find effects operating via export financing lasting two years. When significant amounts of public debt are held by domestic financial institutions, default can also have negative effects on the financial sector (potentially feeding back into further pressure on the public sector if financial sector restructuring is required). Borensztein and Panizza (2008) find that banking crises are significantly more likely when a sovereign default takes place, but not vice versa, although they find little differential impact of sovereign default on industries that are more reliant on external finance. Looking across the economy as a whole though, Hébert and

Schreger (2017) exploit legal judgements that changed the probability of default by Argentina to estimate that a 10% increase in default probability led to a reduction in the value of Argentinian equities by 6%, which is a very large effect. Other evidence (Andrade and Chhaochharia, 2018) suggests smaller but still sizeable effects, concentrated among firms that are particularly reliant on financial intermediation and the government.

Finally, on the political side, Borensztein and Panizza (2008) estimate that debt defaults were associated with: ruling governments seeing a 16 percentage point decline in their electoral support; a doubling of the probability of a change in the head of the executive (e.g. a prime minister or president) in the year of the default and the year after; and an increase in the probability of changes in finance ministers and central bank heads too. This leads them to conclude that the political costs of default are high, potentially leading to increased economic costs as political leaders delay addressing the issue of debt sustainability.

### Delays require bigger fiscal adjustments

As we discuss in the next section, a key consideration for fiscal consolidation is appropriate timing – undertaken too early, a fiscal consolidation can exacerbate a weak macro-economic situation.

However, delaying fiscal consolidation too long not only entails the costs and risks identified above, but also means that the eventual adjustment to tax and spending levels is likely to be larger, in order to address the higher levels of debt and debt-servicing costs that have built up.

This matters, because the economic distortions associated with taxation are typically increasing in the level of taxes – although, as we discuss in Chapter 4, it is possible to reform taxes in ways that make them more efficient, at the same time as raising tax levels. Similarly, larger reductions in spending will make it more difficult to address development goals and have negative effects on both the demand and supply side of the economy.

## 3.2. Design considerations

While fiscal consolidation can have significant benefits when public finances are – or are at risk of – becoming unsustainable, it is not without costs. The spending cuts

or tax rises imposed will make some parts of the population worse off. Moreover, as just highlighted, reductions in public expenditure or increases in taxation reduce aggregate demand via a ‘multiplier effect’. And the unemployment effects, among others, of low aggregate demand can risk longer-term ‘scarring’ effects (e.g. as a result of business failures and difficulties in reallocating labour and capital). An effective fiscal consolidation must be of sufficient scale to meaningfully improve a country’s public finance position, while minimising the negative effects on the economy. Three facets of consolidation measures are therefore crucial to consider: the amount of tax rises and spending cuts to undertake; the timing and phasing of these measures; and the nature of the measures enacted.

### The scale of fiscal consolidation

To state the obvious, the scale of fiscal consolidation required will depend on the budget deficit, debt and debt-servicing costs a country has. At a minimum, the debt-to-GDP and debt-servicing-to-revenues ratios should not be increasing indefinitely, although countries where debt and debt-servicing costs are very high might want to target lower debt and debt-servicing costs.

While there is no commonly agreed definition of the appropriate level of deficit, debt or debt-servicing costs, a number of countries have fiscal rules setting limits or medium-term targets for these fiscal aggregates. For example, the UK’s current rules are for the current budget (i.e. the budget for day-to-day spending) to be in balance in the third year of its fiscal forecasts, for public sector net investment to be less than 3% of GDP, and for debt interest to amount to less than 6% of government revenues. In the EU, countries are meant to run deficits of less than 3% of GDP and have debt below 60% of GDP – although these rules have been suspended as a result of the COVID-19 pandemic, and look unachievable given that major EU countries have debts pushing two times the latter limit (e.g. France and Spain), or more (Italy). And within SSA, many countries have adopted deficit and debt ceilings over the last 25 years (Nandelenga and Ellyne, 2020). Currently, for example, Ghana’s Fiscal Responsibility Act requires a deficit of less than 5% and a primary surplus – although both provisions are temporarily suspended because of the COVID-19 pandemic. The East African Monetary Union Protocol sets out convergence criteria requiring deficits of less than 3% of GDP and debt of less than 50% of GDP, and the West African Economic and Monetary Union requires a deficit below 3% of GDP and nominal debt of below 70% of GDP. In both cases, these rules have also been temporarily suspended due to the COVID-19 pandemic.

It is beyond the scope of this report to assess the appropriateness of these different rules. However, using forecasts and assumptions about how fiscal aggregates and debt interest rates will evolve over time, formulas can be used to estimate the scale of fiscal consolidation required to meet such rules over different time periods.

### The timing of fiscal consolidation

In some cases, there are immediate financing constraints on governments that mean they have to implement fiscal consolidation with immediate effect. But in other cases, governments have some ability to delay the start of consolidation. When considering whether to start now or delay, the government needs to consider several factors including the state of the economy (including the evolution of output gaps and fiscal multipliers), financing conditions, and the time required to plan and implement consolidation measures.

### Economic conditions

The effects of fiscal consolidation on the economy in the short term – and, through scarring effects, in the longer term – are likely to vary with the economic cycle. In particular, when the economy is operating significantly under capacity (i.e. when there is a negative output gap), fiscal multipliers are typically larger. This means that a fiscal consolidation of a given size is likely to have a bigger negative effect on the economy (Auerbach and Gorodnichenko, 2013; Riera-Crichton, Vegh and Vuletin, 2015), although some evidence from the US suggests this may not be the case for tax increases specifically (Arin, Koray and Spagnolo, 2015). Longer-term scarring effects may also be more likely when the economy is already depressed, as the degree of scarring depends on the duration of unemployment, for example, and unemployment spells are typically longer when the economy is weak (Tumino, 2015). Given that the additional economic welfare generated by each unit of income is higher when income is lower (e.g. during a recession), even if fiscal multipliers were the same in recessions, the impact of a given-sized fiscal consolidation on welfare would be greater.

Taken together, these factors suggest that, if possible, fiscal consolidation should be undertaken after the economy has significantly recovered from the COVID-19 pandemic. However, it is worth noting that estimates of fiscal multipliers in SSA – which are admittedly in relatively short supply – suggest that fiscal multipliers are likely to be smaller for developing countries than for high-income countries (see Sheremirov and Spirovska, 2019, and references therein), especially when debt



levels are high, prompting concern about public finance sustainability (Ghosh and Rahman, 2008). This suggests that the need to delay consolidation measures until the economy has recovered may be less than in high-income countries, especially for countries such as Ghana, which have high deficits, debts and debt-servicing costs.

### Financing conditions

The debt-financing conditions that countries face should also influence the timing of their consolidation. For example, if a country is still able to borrow relatively cheaply (and expects conditions to remain favourable), there is less pressure to begin fiscal consolidation immediately. However, if a country faces high borrowing costs (or is particularly exposed to changes in financing conditions because of its debt maturity structure, for example), it may be advantageous to begin consolidation earlier in order to reduce costs and risks. In these circumstances, having a credible fiscal consolidation plan, and beginning to implement it, could improve investor confidence, and help reduce both government and private sector finance costs.

### Timelines for implementation

It is important to allow sufficient time to design, plan and implement appropriate fiscal consolidation measures. Those spending cuts and tax rises that are quickest to implement may not be the most appropriate for the longer term. For example, governments may be able to implement cuts to planned investment spending relatively quickly, but this may entail bigger long-term costs (in terms of lower productivity) than cuts to day-to-day spending. For taxation, it may be relatively easier to change tax rates applied to existing tax bases, whereas it may be more efficient to consider reforms to tax bases or the introduction of new taxes that could increase the efficiency of the tax system as well as raise revenues. The risk of rushed but ultimately inappropriate spending cuts or tax rises is another reason to plan for fiscal consolidation to begin in a couple of years rather than immediately, if possible.

Where financing conditions mean it is necessary to commence consolidation quickly, it may be useful to distinguish between two phases of the consolidation. In the short term, measures that can be quickly implemented but also reversed – such as delays to investment projects or changes in existing tax rates – could be implemented. In the longer term, measures that are more technically or politically

difficult to implement – such as changes to day-to-day spending or reforms to tax bases – could take the place of the short-term measures, minimising the long-run costs of higher taxes and/or lower public spending.

#### The composition of fiscal consolidation measures

The timeline for implementation is just one factor affecting the selection of tax and spending measures to be used in fiscal consolidation efforts. Governments should also consider the implications of different measures for the economy, both in the short term (e.g. via demand-side effects) and in the longer term (when supply-side effects are typically more important), as well as other developmental and distributional objectives. In Chapter 4, we discuss a range of specific options, but there are some general principles.

First, if measures are being implemented when the economy is still relatively weak, it is important to initially prioritise measures that are likely to have lower fiscal multipliers. On the tax side, for example, this would suggest focusing on changes to income- or wealth-based taxes, as opposed to expenditure-based taxes. This is because such taxes are less likely to generate substantial distortions to the timing of economic activity; it is harder to shift one's income over time than it is one's expenditure, at least for employees. Moreover, it is easier to target tax increases to those higher-income individuals who have a lower marginal propensity to consume their income – and hence should reduce their expenditures less in response to an increase in taxation, than lower-income individuals would. On the spending side, freezing or cutting the wages of higher-paid public sector workers will likely depress demand less than cuts to the wages of lower-paid workers or to in-cash transfers to low-income households. Also, cutting spending on larger-scale investment projects, where a significant proportion of inputs are imported, will likely have a smaller negative economic impact than cutting spending on smaller-scale projects that use more local inputs, including labour.

Second, for longer-term measures where there is more time to get the design and implementation right, it is important to try to improve the efficiency of tax and spending at the same time as changing its level, and to ensure changes are consistent with governments' long-term policy objectives.

On the expenditure side of the budget, improvements in efficiency offer the potential of cutting expenditure without reducing the quality or volume of outputs

produced. This may require up-front investment in new equipment/technology and changed ways of working, but it can generate ongoing savings. For example, online education courses may enable more students to access high-quality courses at lower costs, and e-consultations and the use of artificial intelligence improve access to – and reduce the cost of – certain types of medical services. But students and patients, as well as lecturers and health practitioners, need access to appropriate technology to take advantage of these opportunities. There may also be scope to assess whether existing spending policies are meeting their objectives – and, if not, to rationalise them.

On the tax side of the budget, there are several broad types of reforms that can both raise revenues and improve the efficiency of the tax system. This includes introducing and/or increasing taxes on activities that entail negative externalities (such as pollution), and on other tax bases that are relatively unresponsive to taxation (such as land and property). The former can help improve economic efficiency by ensuring that those undertaking such activities bear the full social cost of their actions, not just the (lower) private cost, while the latter minimises the economic distortions caused by taxation. Related to this, taxes can be reformed to reduce the degree to which similar activities are taxed at different rates – these differences can distort behaviour, thus raising the efficiency costs of taxation, and they can be inequitable. Improvements to administration and enforcement can also reduce the scope for avoidance- or evasion-driven behavioural distortions, as well as directly raising revenues. And as with traditional expenditures, tax expenditures can be assessed to determine whether they are meeting their objectives.

These ideas may appear somewhat abstract though, so in Chapter 4 we discuss some specific options for cuts to expenditure and particularly increases in tax revenues, building on these high-level principles.

## 4. Policy options

Having set out the fiscal context for SSA and the broad rationale for, and principles of, fiscal consolidation, in this chapter of the report we set out a number of potential areas for spending cuts or tax rises that governments in the region could consider in the short and medium term. As highlighted in the previous chapter, it is important to consider the impact of measures on aggregate demand (especially in the short term, as countries seek to ensure recovery from the economic effects of the COVID-19 crisis), the longer-term productive potential of the economy, and countries' development and distributional goals.

Broadly, reductions in public investment in physical and human capital, which may have high long-term returns, are unlikely to be desirable in SSA, whereas some areas of less inefficient spending and underutilised and less distortive tax revenue sources hold more promise. Indeed, research suggests that reductions in government consumption and increases in taxes are the less harmful fiscal consolidation option with regards to short- and medium-term growth prospects in SSA (Arizala et al., 2021). Of course, specific areas for reform will differ by country, and it is beyond the scope of this report to look at options in each country. Nonetheless, there are some policy areas that are common to many countries in SSA and offer the potential to improve fiscal balances, while also improving policy in other ways.

### 4.1. Expenditure policies

On the whole, there are good reasons to think that more rather than less public spending would be welcome in SSA, given that public expenditure is so low in the region overall (see Figure 2.1). In 2019, government expenditure in low-income countries in the region amounted to 15% of GDP, compared to 30% in middle-income countries and 38% in high-income countries. Returns on the right investments in human capital and physical infrastructure are likely to be very high and any policies that reduce such investments for the purpose of short-term fiscal consolidation will have ramifications long into the future. In some cases, such policies would ultimately carry a substantial fiscal cost in themselves, to the extent that future economic output is reduced.

However, this is not to say that there are no cases at all where reductions in expenditure could prove more progressive and/or pro-growth than tax revenue-raising measures. For instance, fuel and energy subsidies are regressive because higher-income people are much more likely to own and use vehicles and make use of large quantities of electricity in SSA. Closing or selling state-owned enterprises (SOEs) that make losses for the government could improve the fiscal position of governments both immediately (income from the sale) and in future (removing future losses from government balance sheets). Many other expenditure reductions might also be considered, depending on the specific country context, but short-term fiscal consolidation must be weighed against long-term growth impacts.

### Subsidy reforms

SSA nations subsidise fuel, energy, food and agricultural inputs, among other things. These subsidies have varied goals, such as strengthening production and competitiveness in key sectors, sheltering the population from price fluctuations in global markets, and allowing low-income populations to access basic necessities.

Subsidies can of course represent good policy when used in the right context. However, subsidy policies can be costly, poorly designed and regressive. Where subsidies for fuel and energy still exist, these seem particularly ripe for reform. IMF estimates suggest that pre-tax subsidies (i.e. subsidies that force producer or consumer prices below supply costs) for fossil fuels and electricity are equivalent to around 1% of GDP in SSA overall (Coady et al., 2019), though of course this varies substantially by country. Energy and fuel subsidies distort resource allocation and consumption patterns and can lead to underinvestment, overconsumption and inefficient technology adoption. They may also crowd out other, more socially productive public expenditures – there is a negative correlation between spending on energy subsidies and spending on health and education.

Crucially, energy subsidies are also regressive because higher-income individuals are much more likely to use fossil fuels (e.g. for cars) and be connected to an electricity grid. Across nine African countries, Del Granado, Coady and Gillingham (2012) report that households in the richest quintile spend 20 times as much on fuel and electricity as households in the poorest quintile. Nonetheless, if subsidies were eliminated or reduced, the poor would bear some of the costs. This means that any subsidy reforms should be combined with mitigating measures, such as cash transfers to lower-income individuals to compensate them.

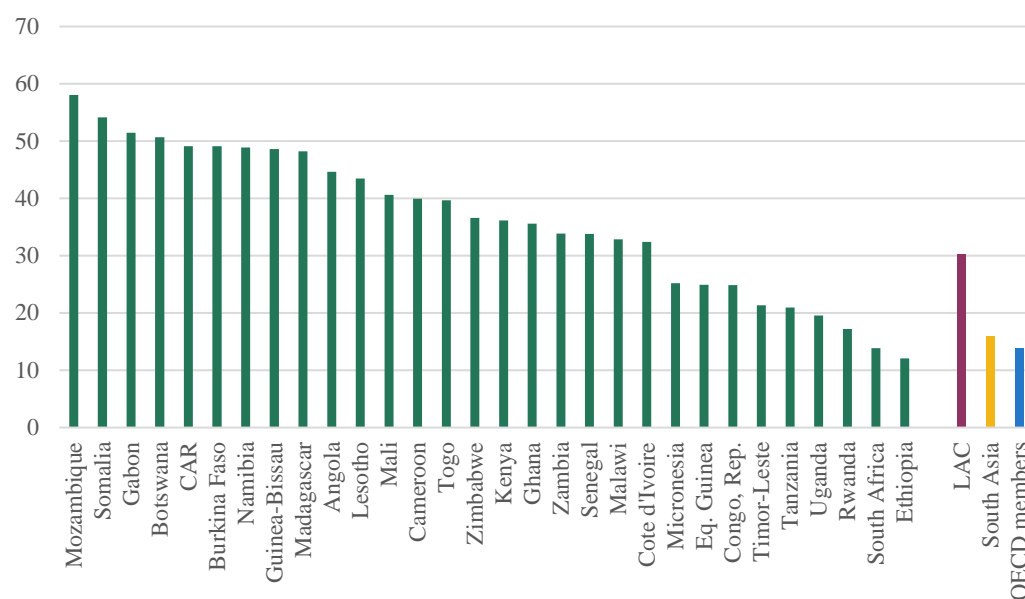
Other common subsidy policies include those for food and agriculture, which are widespread but typically represent a much smaller fiscal outlay. Recent evidence from nine countries in SSA found that these subsidies account for around a third of total public spending on food and agriculture, with the majority of this coming from producer subsidies (e.g. input subsidies), and a smaller share on the consumer side (Pernechele et al., 2021). Reviews of the performance of these subsidies have concluded that they often suffer severe design and implementation failures, crowd out more productive investments, and become entrenched in government budgets (Jayne et al., 2018; Holden, 2019). Thus, these may be another area for reform in some contexts.

### Public sector employee compensation

Lower-income countries are sometimes advised to reform their public sector to increase efficiency and reduce spending. Often, the public sector wage bill comes under scrutiny, given the relatively large share of total expenditure allocated to employee compensation in SSA (see Figure 4.1). For example, Tunisia – which has one of the highest in the world – has recently agreed with the IMF to cut its public sector wage bill. South Africa’s plan for fiscal consolidation, as set out in the Treasury’s Medium Term Budget Policy Statement last October, rests largely on reducing the public sector wage bill (National Treasury, 2020). The World Bank has recommended wage bill savings as an important part of fiscal consolidation plans in Kenya in the coming years (World Bank, 2020a).

There are of course many considerations for reducing the public sector wage bill. This is particularly true as countries still grapple with the pandemic, which will likely have necessitated increased government spending: ensuring essential public services are adequately staffed is a clear short-term priority. The suitability and possible scale of any reductions to the public sector wage bill in a given context can be informed by factors such as employee productivity, the size of any public sector wage premium, and the overall level of employee compensation spending.

Figure 4.1. Compensation of employees (% of total expense)



Note: Latest year available from 2017–19 used for each country or grouping. Values for country groupings based on the median value.

Source: World Bank Development Indicators.

There are a number of ways policymakers could enact a reduction in the public sector wage bill. Reducing the number of employees is one option, which may be preferable if the public sector is perceived to be bloated and overstaffed. Such measures can be difficult to implement, however, so might need to be introduced gradually, for example using hiring freezes or restrictions than ensure inflows of new employees are lower than retirements and other exits. Reductions in real wages (and associated social security benefits) – perhaps achieved by wage freezes or below-inflation increases – are another option. This might be preferable if there is a large public sector wage premium (which may have also grown during the pandemic) – especially as some evidence suggests a weak link between public sector compensation and productivity (World Bank, 2020b). Finally, reviewing and possibly restraining the allowances that public sector employees receive (e.g. for travel), which can be generous, could save money and improve transparency – such measures are the focus of the World Bank’s recommendations for Kenya.

Such reforms can play a role in fiscal consolidation, while also ensuring a competitive job market between the public and private sectors, but they do have several downsides. They may take time to implement, and be politically difficult. In

some contexts, due to severance pay or buyouts, they may represent large upfront costs. Cuts in public services that are already often underfunded and understaffed can have negative short-term and long-term consequences with potential scarring effects: this makes it crucial to target any reductions to relatively unproductive areas.

### State-owned enterprises

SOEs are a major part of many SSA economies, and their successful management and commercial viability makes them an important factor in the public finances of many countries. Their liabilities are, on average, 20% of GDP, assets are 32% of GDP, while their revenues average 7% of GDP, and expenditures 8%. Their losses are on average 1% of GDP (Harris et al., 2020).

Where SOEs make significant quasi-fiscal losses, reforming or selling – or, in extreme cases, closing them – could improve public finances. If sold, there would be a one-off positive effect on the government balance sheet, but such a sale would require that the private sector to feel able to manage the enterprise more effectively and thus earn a positive return. Given that SOEs often operate in core sectors such as energy and other utilities, which may have features of a natural monopoly, private ownership requires a strong regulatory environment not only to avoid overcharging and excess profits, but also to provide a degree of certainty to investors that their investments will not be explicitly or implicitly appropriated.

The removal or reduction of SOE obligations would also have a longer-term positive effect on government finances. There are likely to be ample opportunities for such reforms, though naturally these will vary both across and within countries in the region. A crucial first step though is to ensure that the public funding of SOEs is transparent and that management is accountable to its shareholders: the public (via their government and parliaments). Scrutiny of performance and costs will not only have short-term benefits but also aid with any sale.

## 4.2. Temporary and short-term revenue measures

While there are some areas of expenditure that might warrant reductions in some countries, it is likely that revenue-raising measures represent a more plausible and desirable means of fiscal consolidation in most low-income countries in SSA. Even



before the COVID-19 crisis, the increase of government revenues (domestic revenue mobilisation, or DRM) has been high on the agenda of many governments, as they seek to increase public investment and social protection over the medium term. Indeed, it is estimated that countries in SSA need to raise revenues by 5 percentage points of GDP in order to help meet their Sustainable Development Goals (Gupta and Liu, 2020).

In the context of the economic and political effects of the COVID-19 crisis, certain types of policy may be more desirable or politically feasible in the short term, as discussed in Granger et al. (2020). These measures may play a role in increasing revenues in the short term, relieving financing pressures in the next couple of years, but they are not always suitable for consolidating the structural public finances over the longer term.

### Wealth taxation

Individual net wealth taxes are increasingly discussed in high-income countries as a means of addressing rising wealth inequality.<sup>10</sup> Such instruments are not common in practice though, partly because of concerns about the potential for tax avoidance and evasion to lead to economic distortions and enforcement difficulties, and they are almost non-existent in low- and middle-income countries. However, a number of governments in Latin America have begun pursuing one-off wealth taxes as part of revenue-raising efforts in the immediate context of the COVID-19 pandemic. In December, Argentina introduced a one-off levy of 2%–5.25% on those with assets over 200 million pesos.<sup>11</sup> As of May 2021, the measure had raised nearly three-quarters of what the government expected, equalling around 0.5% of GDP.<sup>12</sup> A similar measure has passed the lower house in Chile,<sup>13</sup> Bolivia has introduced a

<sup>10</sup> See the findings of the Wealth Tax Commission in the UK (<https://www.ukwealth.tax/>), for instance.

<sup>11</sup> See the KPMG Insights article, Argentina – taxpayers’ wealth subject to mandatory and extraordinary contribution, at <https://home.kpmg/xx/en/home/insights/2021/01/flash-alert-2021-027.html>.

<sup>12</sup> Though this could be subject to change, with legal challenges underway. See the article ‘Wealth tax fought by the rich raises more than US\$2 billion’ at <https://batimes.com.ar/news/economy/argentinas-wealth-tax-fought-by-the-rich-raises-us24-billion.phtml>.

<sup>13</sup> See the article ‘Chile lower house approves wealth tax amid spending pressure’ at <https://news.bloombergtax.com/daily-tax-report-international/chile-congress-to-vote-on-wealth-tax-as-fiscal-deficit-soars>.

recurrent wealth tax on the very wealthiest individuals, which has raised more revenue than expected,<sup>14</sup> and a recent bill in Colombia has proposed a temporary net wealth tax of 1%–2% on the richest individuals.<sup>15</sup> Such measures do not have precedent in SSA, but some recent work has begun to study the feasibility and revenue-raising potential of such a measure in South Africa (Chatterjee, Czajka and Gethin, 2020).

Wealth taxes have considerable revenue potential and, if well enforced, they are likely to be extremely progressive – although wealth is not a perfect measure of lifetime resources, and a wealth tax does penalise savers more than those of similar lifetime incomes who happen to have consumed more. Recurrent wealth taxes would distort incentives to save and invest, and tracking assets over time carries recurrent administration and compliance costs which may be significant, especially as evasion responses might also evolve over time. One-off wealth taxes based on wealth at a particular point in time would appear to be more desirable on these margins. If credibly one-off, they would not distort saving and investment behaviour, and they have more limited scope for avoidance and evasion. They could still be made payable in instalments over time, to allow a larger total amount to be raised while minimising the liquidity issues created for wealth-owners.

However, in SSA such measures are likely to face even greater challenges than in high-income countries. Weaker political institutions mean it may be more difficult for governments to credibly commit to such measures being one-off or time-bound in nature, for instance. The revenue potential of such taxes in SSA is also difficult to say, *ex ante*, largely because high-quality data on wealth distributions in countries in SSA are almost completely lacking. In the case of South Africa, however, where the wealth distribution is strikingly unequal, estimates suggest a progressive wealth tax averaging 2.3% on the top 1% of the population could raise revenues of 2.8% of GDP, assuming an avoidance and evasion rate of 30% (Chatterjee, Czajka and Gethin, 2021).

<sup>14</sup> See the article ‘Wealth tax returns twice as much as expected in Bolivia’ at <https://en.mercopress.com/2021/04/28/wealth-tax-returns-twice-as-much-as-expected-in-bolivia>.

<sup>15</sup> See the article ‘Colombia’s Executive branch submitted tax reform bill to Congress’ at [https://www.ey.com/en\\_gl/tax-alerts/colombia-s-executive-branch-submits-tax-reform-bill-to-congress](https://www.ey.com/en_gl/tax-alerts/colombia-s-executive-branch-submits-tax-reform-bill-to-congress).

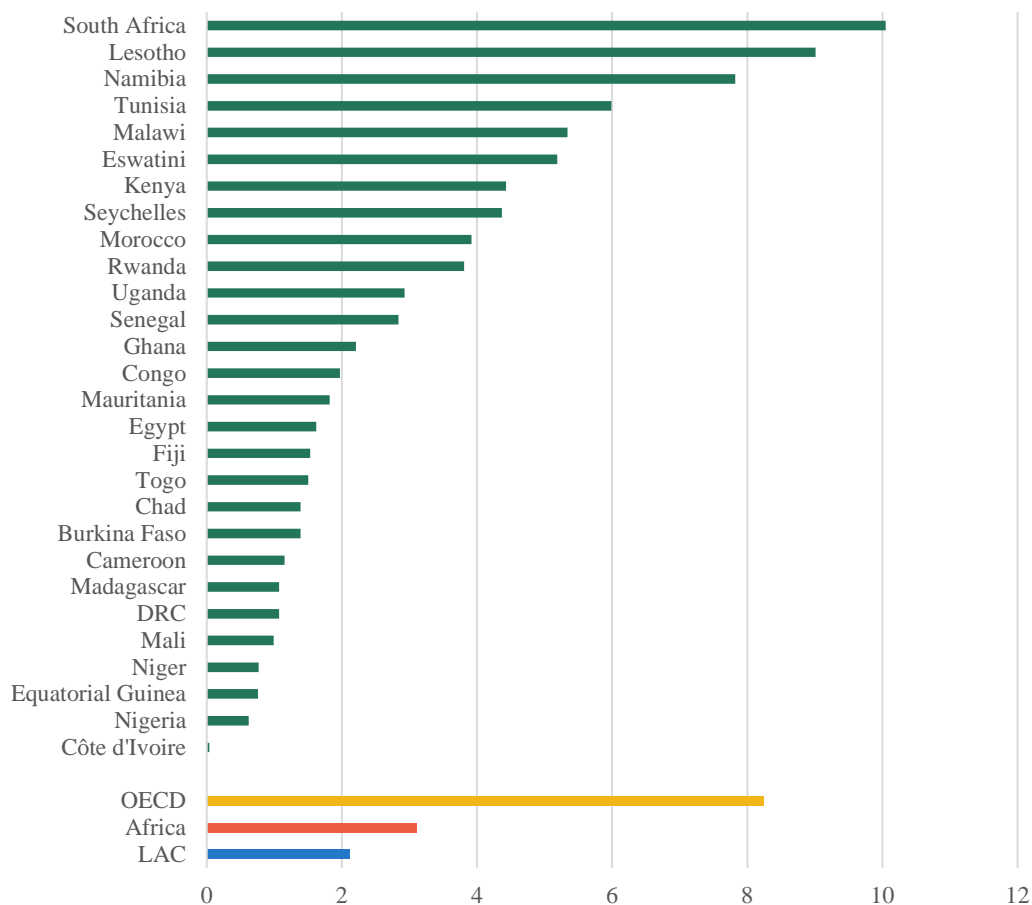
But the most substantive challenge is likely to be administrative feasibility. An individual-level net wealth tax requires comprehensive information on all assets and liabilities of individuals, and this creates challenges in both identifying and valuing people's net wealth. For instance, the use of offshore tax havens to hold certain types of assets presents a particular challenge for enforcement. Evidence from Colombia shows that evasion of wealth taxes (including offshore evasion) is pervasive, but also highlights the potential for credible enforcement threats to shift taxpayer behaviour (Londoño-Vélez and Ávila-Mahecha, 2021). Having said this, administrative capacity is likely to be weaker in most countries in SSA than in Colombia, which is an upper middle-income economy. High Net Worth Units, which identify wealthy individuals to target enforcement activities,<sup>16</sup> represent a first step towards the administration needed for a wealth tax, but these are not necessarily designed to compile comprehensive measures of wealth. These administrative challenges mean that comprehensive wealth taxation is not likely to be a feasible policy measure successfully rolled out across SSA in the short term. Partial taxation of wealth may still hold promise though, as we discuss later.

### Personal income tax rates and thresholds

An alternative, progressive way of raising revenue in the short term is through carefully considered (and potentially time-limited) increases in personal income tax (PIT) rates, or adjustments to thresholds. PIT revenues are considerably lower relative to GDP in SSA than in high-income countries, in large part because of large informal sectors where the crucial withholding of income tax does not take place (e.g. Kleven et al., 2011; Jensen, 2019; see Figure 4.2). Latin American and Caribbean countries also typically have low PIT revenues.

<sup>16</sup> See, for example, Kangave et al. (2016) in the case of Uganda.

**Figure 4.2. Personal income tax revenues as a percentage of GDP in African countries and other regions, 2018**



Note: The figure shows revenue from taxes 'on income and profits of individuals' as a share of GDP. OECD is the Organisation for Economic Co-operation and Development and LAC denotes Latin America and Caribbean.

Source: OECD Global Revenue Statistics.

However, in general, low-income countries also have lower top rates of PIT than high-income countries (Mullins, Gupta and Liu, 2020).<sup>17</sup> Among African countries captured in a KPMG dataset, the average top rate of PIT is below 33%, compared to

<sup>17</sup> Of course, the thresholds at which PIT is payable at different rates are also crucial in understanding the average and marginal tax rates faced at different points of the income distribution. Evidence on this is currently lacking. An ongoing TaxDev research project aims to fill this knowledge gap; see <https://www.taxdev.org/research-projects/taxdev-employment-income-taxes-dataset-eitd>.

42% in the OECD.<sup>18</sup> To some extent, this might be for good reason; if individuals have greater scope to evade taxes on the intensive or extensive margin, then lower rates of tax may represent efficient tax policy. However, where tax is withheld by employers, scope for evasion responses is more limited and, in some countries, there is likely to be scope to increase PIT rates to raise additional revenue. Such tax measures could be marketed as ‘solidarity’ or ‘recovery’ taxes targeted at the best-off members in the economy. Where allowances and exemptions exist within the PIT system, these may also warrant review – we discuss these later.

As a short-term revenue-raising measure, increases in PIT are likely to compare favourably with increases in consumption taxation due to different macroeconomic implications. Decreases in consumption taxes are a favoured fiscal stimulus measure because of their potential to lead consumers to bring forward expenditure, and because they increase real incomes across the entire population – including in low-income households, which have a higher marginal propensity to consume (MPC) and which typically do not pay PIT. For these exact reasons, increases in PIT – especially for those on high incomes – are likely to be a less economically risky fiscal consolidation measure. Intertemporal labour supply is less responsive to wages than consumption is to prices (e.g. Blundell, Meghir and Neves, 1993), and targeted tax increases on high-income individuals imply less of an impact on aggregate demand due to their lower MPC, on average.

### Targeted taxation of businesses

In a similar vein, targeted tax increases on businesses could provide a means of increasing tax revenues in the short term. It is well documented that statutory corporate income tax (CIT) rates have been decreasing around the world for many years but recent months have seen some partial and temporary reversals of this trend as governments seek to reduce fiscal deficits. For example, the UK government recently announced that the main CIT rate will increase from 19% to 25% from 2023. In Colombia, a 3% CIT surcharge was introduced for 2021 and 2022 for banks; similarly, Ghana introduced a 5% tax on the pre-tax profit of banks, to be reviewed in 2024.

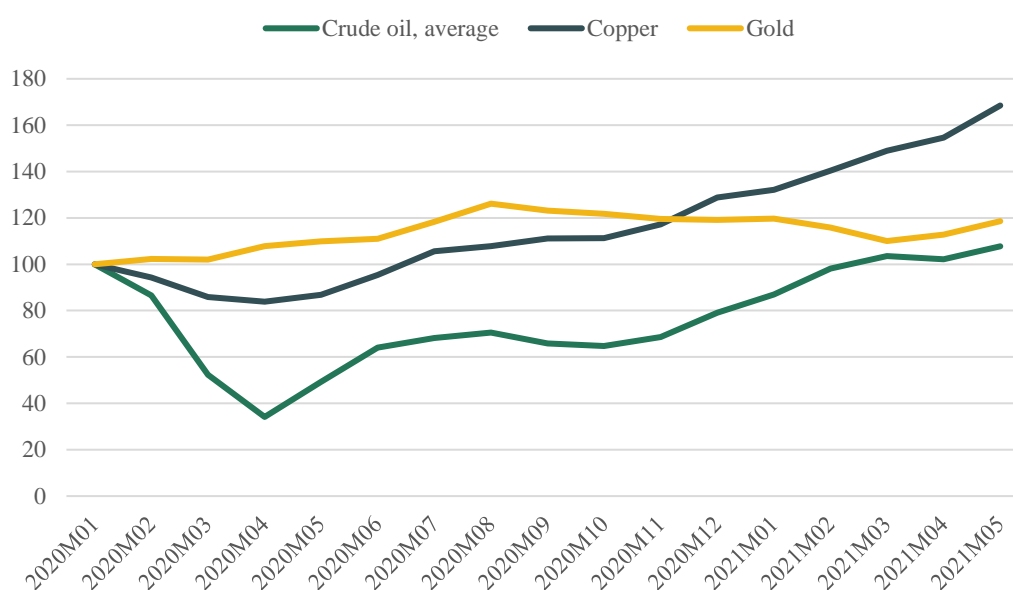
<sup>18</sup> See KPMG’s individual income tax rates table at <https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/individual-income-tax-rates-table.html>.

For countries in SSA, temporary and potentially targeted CIT increases have some appealing properties. By definition, such measures would only apply to profitable companies, addressing concerns of squeezing out businesses trying to recover. While higher CIT rates need to be weighed up against their potential impacts on investment decisions, a credibly temporary increase would not have the same effect on investments that would reap returns a number of years in the future, and by a similar logic, location decisions would not be overly distorted either. In fact, a temporary tax hike might even bring forward some investments in cases where firms are able to adjust the timing and the investment remains profitable. This is because an increased CIT rate increases the value of capital and depreciation allowances (although this would offset some of the revenue gains from higher tax rates). As with the wealth tax, however, the credibility of the policy is crucial here, and there will always be the temptation for fruitful revenue streams to become permanent, even if this might be costly in other ways. Importantly, increases in CIT are likely to be administratively feasible for most governments in SSA; often, the bulk of CIT revenues comes from a small number of very large firms. Although the monitoring and auditing of these firms are not without costs – and, particularly for multinationals, the mechanisms for avoidance are varied – this suggests that such reforms could be implemented practically.

It may also be worth considering an increase in taxes on particular firms or sectors that have seen higher profits in the past 18 months. For instance, commodities such as gold and silver saw their prices rise substantially during 2020 (see Figure 4.3), and the producers of such goods are likely to have experienced windfall profits as a result of these conditions. An even wider range of commodities are now seeing prices increases, and firms in telecommunications, e-commerce and IT may also have benefitted in some places.<sup>19</sup> CIT increases could be targeted to these sectors; changes to royalty rates or the introduction of special time-limited taxes to redistribute these windfalls back to the public sector could alternatively be considered.

<sup>19</sup> Although governments around the world have understandably taken steps to ensure these services are affordable to the population, including through tax reductions, the taxation of profits is a different matter and the incidence of these taxes could feasibly be different.

Figure 4.3. Selected commodity prices (January 2020 = 100)



Source: World Bank Commodity Price Data (The Pink Sheet), June 2021.

## 4.3. Permanent and long-term revenue measures

The measures discussed above are particularly suited for raising revenue in the short term and/or on a temporary basis. However, over a longer time period, other policy areas become more feasible and/or more appealing. These policy areas have substantial revenue potential in principle and can also satisfy other criteria for good tax policy – in terms of efficiency or progressivity, for instance. Thus, even for countries that do not pursue fiscal consolidation, these areas may represent an opportunity to increase their ability to finance public investments or social programmes to meet development goals.

### ‘Green’ taxation

In the quest to raise more government revenue, consensus choices are rare. However, among economists there is near-universal agreement that the correct pricing of activities that produce ‘negative externalities’, in order to align

(marginal) social costs with (marginal) private costs, constitutes efficient policy.<sup>20</sup> Taxes represent one way to do this, and also raise revenue for the government.

‘Green’ taxes could incorporate a number of different types of tax instruments. Already, most countries in SSA levy charges on the sale or use of polluting fuels and vehicles, for instance, and Nair et al. (forthcoming) provide a comprehensive overview of how these compare across countries, and where the opportunities for reform might be. Green taxes on motoring and energy use can represent a progressive and efficient way of raising revenue. The introduction of or an increase in these taxes would provide an opportunity to use post-pandemic tax policy reforms to address externalities from motoring and fossil fuels, including local air pollution and congestion. Because higher-income individuals in countries in SSA are disproportionately likely to use motorised vehicles and to use electricity more, green taxes are likely to be progressive. They also represent a relatively low administrative burden because governments already observe and levy taxes or charges on vehicle imports, purchases and ownership, as well as sales of key fuels and electricity production.

Several countries in SSA already raise substantial tax revenue from green taxes, but the configuration of these taxes is often inefficient. Fuel taxes are set at moderate levels, but there are many exemptions and issues of undercollection. Fuel stabilisation policies also often end up subsidising fuel (Nair et al., forthcoming) because of the political difficulty of raising target price levels, which can lead temporary stabilisation policies to become permanent subsidies. Ownership taxes are often negligible, while taxes on purchases and imports, particularly of used cars, are high in a number of countries. High taxes on the imports of even moderately used cars are perceived as an industrial policy measure encouraging domestic manufacturing. However, they can hurt competitiveness in a region that has low levels of motorisation.

Reducing or eliminating fuel subsidies and raising fuel taxes along with other efficient tax measures (e.g. ownership taxes that vary according to pollution ratings, and geographically according to congestion and pollution levels) can therefore increase efficiency and raise revenue. In the case of taxes on imported vehicles, it is

<sup>20</sup> See, for example, a poll of economists regarding pricing greenhouse gas emissions at <https://www.igmchicago.org/surveys/pricing-emissions/>.



plausible that some countries could raise more in tax revenue by lowering rates on certain kinds of vehicles (i.e. a Laffer effect), while also improving competitiveness.

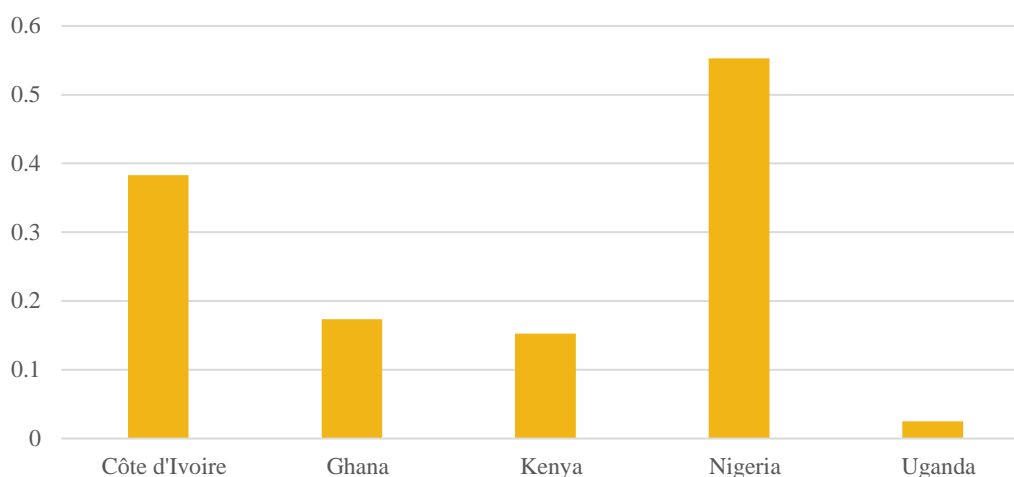
Beyond reforming and potentially increasing rates of existing tax measures, explicit carbon taxation may be another area for revenue-raising reform. Countries in SSA are not where such taxes are most needed in order to address the overall market failure of greenhouse gas emissions; in 2017, these countries accounted for less than 4% of (production-based) emissions, and cumulatively they have produced only 2.7%.<sup>21</sup> Nonetheless, the basic appeal of carbon taxation remains, and measures that steer investments away from technologies that soon may become costly can avoid important ‘lock-in’ effects (e.g. Balboni, 2019). In addition, existing evidence suggests that carbon pricing may be slightly progressive in low-income countries (Ohlendorf et al., 2021). In some cases, revenue potential from carbon taxation is substantial. For example, the OECD has estimated that pricing carbon at EUR 30/tCO<sub>2</sub> could raise revenues equivalent to around 0.5% of GDP in Nigeria and 0.4% in Côte d’Ivoire (see Figure 4.4), over and above reforming existing subsidies (OECD, 2021a). Overall, the IMF has estimated that the potential revenue gain from reforming subsidies and taxes on fossil fuels to correctly price for externalities is nearly 4% of GDP.

While green taxes are progressive and represent an opportunity for improving fiscal positions, while reducing externalities and promoting green growth agendas, care must be taken to implement mitigating measures. These measures are needed to compensate lower-income people who bear some of the burden of reduced subsidies and increased taxes. Moreover, policymakers should also be mindful of the potential network effects of energy and transport systems – to the extent that there are positive externalities to this infrastructure, this might partially offset the rationale for higher taxation on these goods and services. Liu (2019) shows why there is a case for subsidisation of upstream sectors in developing countries. Finally, the case of carbon taxation presents particular challenges because of the global nature of the problem. The unilateral adoption of carbon taxation raises risks for international competitiveness and associated carbon leakage. This makes the

<sup>21</sup> See CO<sub>2</sub> emissions by H. Ritchie and M. Roser at <https://ourworldindata.org/co2-emissions>.

consideration of border policies – including adjusted tariffs for imports and possibly carbon rebates for exports – a possible part of a carbon tax proposal.

**Figure 4.4. Estimated revenue potential from carbon pricing for selected countries in SSA (percentage of GDP)**



Note: Estimates based on carbon price of EUR 30/tCO<sub>2</sub>.

Source: OECD (2021a).

### The value-added tax base

Value-added tax (VAT) is a disproportionately important source of tax revenue in SSA compared with richer countries. According to the OECD, in 2018, VAT accounted for 20.4% of OECD tax revenues, on average; in Africa, the figure was 29.7% (OECD, 2021b). While this reflects the fact that revenues as a percentage of GDP are even lower for other taxes rather than VAT/GDP ratios necessarily being higher, it does highlight the dependence of African governments on this one source of revenue. Despite the relatively greater revenue yield from VAT than from other taxes, there remain ample opportunities for VAT reform in many countries in SSA, which would increase funds available to government. This is highlighted by the exceedingly low VAT ‘C-efficiency’ (i.e. the ratio of actual VAT revenues and the product of domestic consumption and the standard VAT rate) estimated for the region, which provides an estimate of the revenue gap compared with a VAT system without special reduced rates or exemptions and which is perfectly enforced. In SSA, this is estimated to be 35%, suggesting that VAT revenues are still only around one-third of their potential (de Mooij et al., 2020). The world average for C-

efficiency is estimated to be 51%, and is even higher in emerging and developing Asia.

The African VAT revenue gap comes partly from non-compliance, which is a constant challenge for tax authorities with no comprehensive short-term solution, though we shortly discuss possible interventions that may have some promise at the margin. However, part of the gap also comes from policy choices, specifically from the common practice of offering reduced rates or exemptions on certain sectors or goods and services. Harris et al. (2021) estimate that extending VAT to currently untaxed goods and services, and excluding exemptions that may be in place for administrative reasons (such as housing costs or public services could raise revenues of up to 2% of GDP in Senegal, for instance (Table 4.1).<sup>22</sup>

**Table 4.1. Revenue cost of VAT exemptions for four countries in SSA**

| Country  | Cost of exemptions and reduced rates (% of GDP) |
|----------|---|
| Ethiopia | 0.6%  |
| Ghana    | 1.0%  |
| Senegal  | 2.0%  |
| Zambia   | 1.7%  |

Note: The table shows estimated cost of existing VAT exemptions, excluding those applying to small firms, financial services, public services and housing costs.

Source: Harris et al. (2021).

For some types of consumption, lower VAT rates may be justified on the basis of administrative costs, or even on efficiency grounds. For instance: some goods and services (e.g. financial or public services) do not have an easily observable price; exemptions reduce the number of taxpayers that the revenue authority needs to

<sup>22</sup> Harris et al. (2021) is an updated but as yet unpublished version of Harris et al. (2018).

manage, including small firms with low revenue potential; and lower VAT rates can in theory be justified for goods and services where demand or supply is more responsive to prices. However, differential VAT treatments create administrative costs as well (e.g. from policing product boundaries, or processing refunds for low-VAT firms) and, in the absence of well-evidenced justifications, policymakers should avoid distorting choices across goods and services via application of different tax rates. Importantly, VAT exemptions have the effect of creating the taxation of intermediate inputs and are therefore in direct contradiction to the goals of the main design features of the tax.

Perhaps the more widespread motivation behind lower VAT rates is equity considerations. Policymakers might rightly be worried that expanding the VAT base would disproportionately harm poorer households and/or would increase poverty. However, recent research suggests that in many contexts, such concerns may be overstated. Harris et al. (2021) show that, for the four countries in SSA they studied, existing preferential VAT rates are not progressive, and are perhaps even slightly regressive in Ethiopia and Zambia. In cash terms though, the benefit received from reduced VAT rates is many times larger in better-off households, largely because of the simple fact that such households spend much more on beneficiary goods. Moreover, this is before taking into account differential propensities to consume from untaxed, informal sellers across the income distribution. Bachas, Gadenne and Jensen (2020) show that informal consumption is much more prevalent in low-income households in SSA, suggesting that, in practice, extending VAT to more goods would be even more progressive.

Overall then, a wider VAT base has substantial revenue potential, would likely be largely borne by richer households, and would have efficiency and administrative benefits too. However, this still does not make this an immediate policy prescription for all countries in SSA. Even if largely paid by richer households, a wider VAT base could still (further) impoverish some poorer households. As shown by Harris et al. (2021), such effects could be substantial if the reform was undertaken in isolation. However, in principle, the recycling of some of the revenue gain could fully compensate poor households on average, even if recycled in a completely untargeted way. The practicality of such revenue recycling is one issue, which would require context-specific solutions; another is the political economy, as a broader VAT base is a proposal that has attracted controversy in many contexts.

## Other tax expenditures and incentives

VAT expenditures represent substantial foregone revenue for many governments in SSA but tax expenditures are prevalent for many other tax types too (Gupta, 2018). Some taxpayers who pay CIT may receive income tax holidays, and PIT systems sometimes offer allowances for taxpayers with certain characteristics, for instance. Such policies can be motivated by a wide range of factors, and their effectiveness in achieving stated objectives varies greatly. For instance, investment incentives can be justified in the case of mobile investments with positive social returns but are very poorly targeted when investments are designed to exploit location-specific rents, such as natural resources or agglomeration benefits.

The wide variety of different policies subsumed under ‘tax expenditures and incentives’ means that it is not simple to draw conclusions on their broad efficacy. However, it is clear that tax expenditures are typically opaque, costly in terms of revenue, and have the potential to create inequities. The Global Tax Expenditures Database (GTED) has found that only 19 of 73 African countries reported at all on their tax expenditures between 2000 and 2019, and when information is provided, it is generally at an aggregated level, rather than provision-by-provision (Redonda and Gupta, 2020). This lack of transparency makes it challenging to produce consistent estimates of foregone revenue – data are often not available or are not comparable across jurisdictions. Notwithstanding this challenge, available estimates suggest that tax expenditures represent a substantial fiscal cost to governments in SSA. Redonda and Gupta (2020) estimate their cost at 2.9% of GDP in Africa, on average, using data from the GTED.<sup>23</sup> They stress, however, that this should be viewed as a lower bound because of non-reporting of many tax expenditures.

Tax expenditures can create horizontal inequities, granting preferential treatment to individuals or firms. Overall, they are also likely to be regressive, and thus damaging to vertical equity. Allowances in the PIT system only accrue to PIT taxpayers, disproportionately made up of high-income individuals in SSA. The incidence of CIT incentives is perhaps complex, but the owners and employees of corporate taxpayers in SSA are again likely to be in the upper part of national income distributions.

<sup>23</sup> Note that, in some cases, estimates include tax expenditures arising from the definition of the VAT base.

These factors all suggest that governments in the region could consider reviewing tax expenditures across the board, as well as those in the VAT system already discussed. However, the heterogeneity of policies in this area means that a case-by-case approach is sensible, and it would be advisable to monitor the effects of removing these incentives. At the very least, governments should take steps to report on the cost of existing policies.

## Property taxation

Property taxes are common in developed countries but are not used nearly as much in low-income countries, including in SSA. They account for 2.2% of GDP in developed countries, but only for 0.4% of GDP, on average, in Africa – this relative discrepancy is much larger than for any other major tax type.<sup>24</sup> This suggests that, in principle, there may be scope for increasing tax revenues from property taxation in SSA.

In some respects, property taxes have desirable features similar to those noted for one-off comprehensive net wealth taxes described above. They can be designed to be progressive and – to the extent that property taxes apply to land – they are appealing from an efficiency perspective because the supply of land is not responsive to its price. In addition though, a key advantage of property taxes over other taxes on wealth is that because properties are easy to observe, property taxes should be easier to assess and harder to evade.

There are, however, specific challenges to address in order to expand property taxation in SSA. One is administrative capacity, because property taxation requires some consistent method of valuation, for example, and up-to-date property registers may be unavailable. More widespread use of IT and GPS systems to register such information, which can be easily accessed and updated, potentially hold some promise in this regard. McCluskey et al. (2018) document that investment in IT systems has shown benefits for processes and for revenues in cities in Tanzania, Kenya and Zambia. However, Prichard and Fish (2017) caution that, more generally, IT systems have not always been successful for administering property taxes, and they emphasise the need for locally appropriate and managed systems

<sup>24</sup> See the African Property Tax Initiative at <https://www.ictd.ac/programme/apti/>.

that are linked to other reforms and other levels of government to ensure sustainability.

Beyond the administrative challenges of registration and valuation, authorities also need to grapple with non-compliance. For instance: Okunogbe (2021) estimates that 5%–10% properties in Liberia are registered for taxes; Knebelmann (2019) estimates that 20% of plots in Dakar were on the tax roll in 2018, and only 12% of owners paid their taxes; Brockmeyer et al. (2021) find that 40% of property taxpayers in Mexico City are delinquent on their payments. Recent research has uncovered that different enforcement interventions can shift this margin substantially though. Brockmeyer et al. (2021) find that letters emphasising fines and sanctions triple the likelihood of payment, and Okunogbe (2021) finds evidence that enforcement activities can be most effective when tax notices identify the delinquent taxpayer and are dependent on past enforcement activities in an area. Balán et al. (2020) show that, in the DRC, utilising the local knowledge of elites in enforcement substantially improves compliance.

However, a cautionary tale in relation to increased or improved enforcement of property taxes comes from Brockmeyer et al. (2021). In contrast to taxes on income and consumption, property taxes are levied on an illiquid stock, and thus have the potential to exacerbate liquidity problems in low- and middle-income countries, where such constraints are pervasive. Indeed, this research finds that while increased enforcement activities improve compliance, this leads to households reducing consumption. Therefore, they conclude that increasing rates is welfare-improving, but improved enforcement is not, overall. Thus, while property taxes hold promise in SSA from a revenue perspective and compliance can be partially addressed with the right approach to enforcement, a broader view should also be taken in policy design.

### Administration and compliance reforms

So far, the policy options considered have focused on tax policy but, in addition to changing tax rates, introducing new taxes or broadening the de jure base of existing taxes, countries can achieve higher revenues by improving the administration of existing taxes and achieving better compliance, thereby expanding the de facto tax base. It is primarily this margin that can account for the chasm in tax-to-GDP ratios between countries in SSA and high-income countries, rather than differences in tax rates (Besley and Persson, 2014). Expanding the tax net and improving compliance

are big challenges, for which there is no silver bullet; indeed, such outcomes are a byproduct of development (Besley and Persson, 2013, 2014; Jensen, 2019), as information becomes increasingly available to authorities and they are better resourced to enforce rules. However, at the margin there are many administrative interventions that can improve compliance and revenues, as highlighted in recent research.

Much research has focused on administrative reforms to VAT, given its importance in revenue collections in low- and middle-income countries.<sup>25</sup> For business-to-business sales, the ‘self-enforcing’ properties of VAT created by asymmetric evasion incentives for upstream and downstream firms have been shown to bear out in reality (Pomeranz, 2015), though challenges do remain in enforcement; for example, Almunia et al. (2020) find evidence of systematic misreporting of transactions that could easily be cross-checked by the authorities. Better issuing of invoices and receipts, including those through electronic billing machines (e.g. Eissa et al., 2014), combined with sufficient resources to utilise this information, can offer a partial solution. The more substantive challenge for VAT enforcement comes at the retail stage, however, because of the ‘last-mile problem’, when consumers do not have an incentive to ensure VAT is paid. Governments can use a range of different approaches to address non-compliance at this stage. For instance, Naritomi (2019) shows that consumer lotteries, which encourage consumers to demand a VAT receipt, can substantially improve VAT revenue. Tax rebates to consumers might similarly incentivise them to ask for receipts.

More generally, a range of different enforcement activities can be utilised to increase revenues. Basri et al. (2021) find very large returns to enforcement capacity in the context of corporate tax in Indonesia – moving top firms into Medium Taxpayer offices with greater administrative capacity doubled revenue yields. Credible enforcement threats can be a persuasive and cost-effective way of improving tax compliance, as indicated by randomised letter experiments, for instance, which usually find significant impacts of tax payments (for a review, see Mascagni, 2018). Effective audits can directly raise revenue by uncovering non-compliance but these can also have dynamic effects on audited taxpayers (Advani, Elming and Shaw, 2019) and help to maintain a credible enforcement threat for non-audited taxpayers. Manual screening and risk-based audit selection can be

<sup>25</sup> See Gerard and Naritomi (2018) for a review.



important elements of a tax audit strategy, although the former can be subject to human error or bias, and the latter requires good data. However, tax authorities can also consider random audits, which can build a credible audit threat and also generate better evidence on the true effectiveness of audits (Khwaja, Awasthi and Loeprick, 2011).

Authorities can also explore leveraging social and positive incentives for compliance. Evidence from Pakistan has shown how taxpayers respond strongly to social incentives to pay taxes (Slemrod, Rehman and Wasseem, 2020), suggesting that publicly celebrating taxpayers in some way could be effective in SSA. In Rwanda, a taxpayer education programme had a positive impact on taxpayer knowledge and filing (Mascagni et al., 2017). More generally, building a culture of tax compliance – a culture of ‘tax morale’ – is something that many governments strive to do, although the literature on the effectiveness of interventions that try to shift this margin is so far mixed (Luttmer and Singhal, 2014).

## 5. Conclusion

The COVID-19 pandemic has hit the public finances of nearly all countries. The direct effects of the pandemic and government-imposed restrictions on economic activity have led to disruptions in supply and demand, with the loss of incomes and jobs has further amplifying the demand shortfall. In high-income countries, governments have responded vigorously, first protecting workers and firms and later implementing economic stimulus packages. In developing countries, including low-income countries in SSA, government responses have been more limited, at least in part because of restricted fiscal space. But the pandemic has also slowed growth and increased deficits in countries in SSA, which in turn means higher debt and debt-servicing costs in a number of countries that were already heavily indebted and spending a large share of their budgets on debt servicing.

In this report, we have assessed the fiscal situation of countries in SSA, finding that many of them may need to consider some fiscal consolidation measure to reduce debt-servicing costs and increase competitiveness. The exact size of the fiscal consolidation needed will depend on the macroeconomic conditions but also on the target level of debt and debt-servicing costs, and crucially on international developments with respect to concessional finance, debt restructuring and debt relief.

While difficult in the short term, some research suggests that in the longer term the consolidation of public finances has a number of benefits. Debt financing, particularly for countries that borrow at high interest rates, is costly. It is ultimately unsustainable, eventually necessitating even higher distortionary taxes, and it can crowd out public spending and investment, and displace capital. But it also makes countries more vulnerable to shocks and reduces their fiscal space to deal with those shocks – the recent COVID-19 crisis being a case in point.

The key is to develop fiscal consolidation plans that minimise negative impacts on output and the potential for scarring, while maximising longer-run positive impacts on the structural public finances. In principle, fiscal consolidation can be achieved through cuts to public spending, with areas such as price subsidies, the public sector

payroll and operation of state-owned enterprises worth examining. However, given that, overall, increases rather than decreases in public expenditure will be required over the next few years (not least to help meet the Sustainable Development Goals), it is likely that increases in tax revenues would have to be the main focus for fiscal consolidation measures.

Short-term revenue-raising measures could include a one-off wealth tax, and temporary increases to higher rates of PIT and CIT, potentially targeted at sectors that have done well during the pandemic. Such measures would likely have smaller negative effects on demand than, for example, taxes on expenditure, and if credibly one-off or short term, they would have a limited distortive effect on investment decisions. Whether governments in SSA could credibly commit to such measures being one-off or temporary is an important consideration though; if the measures are longer term (or just perceived to be longer term), such measures would generate larger distortions to the economy and, potentially, avoidance and evasion problems.

Longer-term tax measures should seek both to improve the efficiency of the tax system and to raise revenues. Areas that warrant consideration include green taxes and property taxes, as well as the rationalisation of tax expenditures and exemptions, not least in relation to VAT. Research suggests a number of potentially fruitful reforms to administration and enforcement that can increase tax revenues as well, though such reforms are unlikely to generate sufficient revenues in the short term to allow countries that require significant fiscal consolidations to avoid increases in tax rates entirely.

Overall, the COVID-19 pandemic has exacerbated what was an already challenging environment for public finances in many countries in SSA. But there are a number of areas where policy and administrative reforms could help raise revenues in an equitable and efficient manner.

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