

TRADE LIBERALIZATION AND TAX REFORMS
IN
CAPE VERDE

by

Annika Marking



NATIONALEKONOMISKA INSTITUTIONEN
VID LUNDS UNIVERSITET

Department of Economics at the University of Lund

2010:4

Minor Field Study Series

No. 202

Mailing address:
Nationalekonomiska Institutionen
Box 7082
S-220 07 LUND
Sweden

ISSN 0283-1589



EKONOMIHÖGSKOLAN
Lunds universitet

Department of Economics
Bachelor's Thesis
Minor Field Study
2009

Trade Liberalization and Tax Reforms in Cape Verde

Annika Marking

Supervisors
Yves Bourdet
Åsa Hansson

Abstract

When a country liberalizes trade through lowering taxes on imports, it stands before a number of challenges. Recovering lost trade tax revenue is one of them. Cape Verde is one of the countries that are currently negotiating an Economic Partnership Agreement with the EU and studies predict that the tariff reductions resulting from the agreement may have a severe impact on Cape Verde's government revenue. During the past decade, several tax reforms have been carried out in Cape Verde, including both taxes on international trade as well as domestic taxes. This study analyzes the revenue effects of these reforms and discusses Cape Verde's prospects of recovering future lost tariff revenue. Further, in an analysis of the effects of the tax reforms on the overall economy, a number of aspects laid out in the theoretical framework are examined in order to determine the tax system's accordance with recommendations from tax theory for development. The study concludes that total tax revenue has increased as a result of reforms and the tax system has been improved, mainly through simplifications, rate reductions and improved collection efficiency. Taxes on international trade have become relatively less important in total government revenue and given way to domestic consumption taxes. In spite of weaknesses still prevalent in the system, the fact that domestic taxes have proven to be efficient enough to increase at a speed higher than GDP growth presents positive prospects regarding further trade liberalization.

Keywords: Cape Verde, Tax Reforms, Trade Liberalization, Tax Policy for Development, Government Revenue, the VAT.

Acknowledgements

This study would not have been possible without the following people and organizations: Sida, providing financial support; my supervisors Yves Bourdet and Åsa Hansson; all helpful people at the Ministry of Finance, in particular at the Directorate-General of Customs (DGA), providing an office; the National Statistics Institute (INE); the Ministry of Foreign Affairs, The Ministry of Economy, Growth and Competitiveness (MECC); Leif and Eva Norman, providing general support and assistance; Arnaldo Lopes, providing assistance and connections; Xaya and Vadú, showing great hospitality; Francisco de Paula Rodrigues, providing assistance and connections; and Christer Marking, providing extensive comments on earlier drafts as well as general support. Thank you!

Abbreviations and Acronyms

ACP	African, Caribbean and Pacific group of countries
ADEI	<i>Agência para o Desenvolvimento Empresarial e Inovação</i> (Agency of Corporate Development and Innovation)
BCV	<i>Banco de Cabo Verde</i> (The Central Bank of Cape Verde)
CIF	Cost, Insurance and Freight
CRTD	<i>Comissão de Reforma da Tributação sobre a Despesa</i> (Indirect Tax Reform Commission)
DGA	<i>Direcção Geral das Alfândegas</i> (Directorate-General of Customs)
DGCI	<i>Direcção Geral das Contribuições e Impostos</i> (Directorate-General of Tax)
DGO	<i>Direcção Geral do Orçamento</i> (Directorate-General of the State Budget)
ECOWAS	Economic Community of West African States
EPA	Economic Partnership Agreement
FDI	Foreign Direct Investment
ICE	<i>Imposto sobre o Consumo Especial</i> (Special Consumption Tax)
IGAE	<i>Inspecção Geral das Actividades Económicas</i> (General Inspection of Economic Activities)
IMF	International Monetary Fund
INE	Instituto Nacional de Estatística (National Statistics Institute)
IUP	<i>Imposto Único sobre o Património</i> (Single Property Tax)
IUR	<i>Imposto Único sobre o Rendimento</i> (Single Income Tax)
LDCs	Least Developed Countries
MECC	<i>Ministério da Economia, Crescimento e Competitividade</i> (Ministry of Economics, Growth and Competitiveness)
MF	<i>Ministério das Finanças</i> (Ministry of Finance)
MNE	<i>Ministério dos Negócios Extranjeros</i> (Ministry of Foreign Affairs)
NIF	<i>Número de Identificação Fiscal</i> (Fiscal Identification Number)
NOSi	<i>Núcleo Operacional para a Sociedade de Informação</i> (Operational Group for the Information Society)

Sida	Swedish International Development Cooperation Agency
UNDP	United Nations Development Programme
VAT	Value-Added Tax
WTO	World Trade Organization

Table of Contents

1. Introduction.....	8
2. Theoretical Framework – Tax Policy in Developing Countries	11
2.1. General Notes on Taxation in Developing Countries	11
2.1.2. The informal sector.....	11
2.1.3. Tax administration.....	12
2.2. Efficiency	12
2.2.1. Simple tax design	13
2.2.2. Broad tax base	14
2.3. Equity	16
2.4. Growth, Redistribution and Poverty	17
2.5. Fiscal Federalism.....	20
2.6. The VAT	20
2.6. Tax Reform in the Context of Trade Liberalization	22
3. Trade Liberalization in Cape Verde.....	24
3.1. The Economy of Cape Verde	24
3.2. The Economic Partnership Agreement	25
3.3. Implemented Trade-Liberalizing Policies.....	26
3.4. Impact of Trade Liberalization on Tariff Revenue	27
4. Tax Policy in Cape Verde	30
4.1. The Public Sector	30
4.2. Indirect and trade taxes	31
4.2.1. Structure of Import Taxes – Pauta Aduaneira	31
4.2.2. The Special Consumption Tax – Imposto sobre o Consumo Especial	32
4.2.3. The VAT – Imposto sobre o Valor Acrescentado	32
4.3. Direct taxes.....	34
4.3.1. The Single Income Tax – Imposto Único sobre o Rendimento	34
4.3.2. The Single Property Tax – Imposto Único sobre o Patrimônio	35
4.4. Other taxes.....	35
4.5. Administration.....	36
4.6. Current Tax Design	38
4.6.2. Fiscal incentives	39
4.7. Revenue Effects.....	41

5. Evaluating the Cape Verdean Tax Reforms	45
5.1. Efficiency	45
5.2. Equity	49
5.3. Federalism	49
5.4. Redistribution and Poverty	50
5.5. Economic Growth	53
6. Conclusions and Policy Implications.....	56
References.....	59

1. Introduction

Since 1975 the African, Caribbean and Pacific (ACP) group of countries have enjoyed non-reciprocal preferential access to the European Union market. Due to this agreement's discriminatory component against other developing countries, it is not compatible with WTO regulations and the time has come for the preferences to be phased out. The ACP countries are therefore currently negotiating Economic Partnership Agreements (EPAs) with the EU which will put the ACP countries to the challenge of liberalizing trade barriers on "substantially all trade".¹ This entails gradually reducing or eliminating tariffs levied on imports from the EU.

The EPAs are intended to provide the ACP countries with possibilities of enhancing economic growth and development through increased trade, investment and technological progress opportunities. Nonetheless, these gains are accompanied by challenges. One of them is recovering the loss of tariff revenue. To some of the ACP countries, the tariff revenue from imports from the EU constitutes a substantial part of total government revenue. Hence, there is a risk that the elimination of customs duties on imports from the EU will lead to a large decline in government revenue, which could be troubling for developing countries in need of growth-enhancing public goods. Some studies suggest that the EPAs may result in government revenue losses that exceed the gains from trade and thereby reduce welfare.² It is therefore of outmost importance that the trade liberalization is accompanied by complementary policies and in some countries, tax reforms will be required in order to alleviate the fiscal effects of the EPAs.³

Cape Verde is assumed to be one of the countries that will suffer the most from tariff revenue losses, mainly because such a large share of the country's imports originates from Europe, and various studies predict a severe impact on its economy.⁴ However, these estimations do not consider the potential positive growth effects of fully implemented EPAs. If economic growth is enhanced by the agreement, there is

¹ PricewaterhouseCoopers: 2007

² Borrman et al: 2005: p. 172

³ Simplice et al: 2007: p. 19

⁴ Hinkle et al: 2006: p. 273, Busse et al: 2004: p. 27, Borrman et al: 2005: p. 171

scope for increased government revenue, as long as there are channels through which the gains from trade can be transferred to the government. In other words, for Cape Verde, a sustainable and efficient domestic tax system is one of the factors that could ensure the success of the EPAs.

In many ways, Cape Verde is a rather special economy. It is a small island country located some 450 kilometers from the west coast of the African mainland. There are only approximately half a million inhabitants spread out on the different islands and due to poor natural resources and the small market, production possibilities are few. This forces many Cape Verdeans to migrate and the expatriate population is now larger than the domestic.⁵ Further, due to the modest production, exports cover little of imports and approximately 82 per cent of all food must be imported.⁶ When discussing the sustainable and efficient tax system mentioned above, all these features of the economy are important to keep in mind.

The objective of this study is to analyze and evaluate the tax reforms that have been implemented in Cape Verde during the past decade, in part as a result of trade liberalization. The term trade liberalization refers to the reduction of taxes on trade, i.e. tariffs and other customs duties.⁷ It will point out strengths and weaknesses of the tax design and attempt to formulate further policy implications.

Reforms of the tax system, including the structure of trade taxes⁸ as well as domestic taxes, and their effects on government tax revenue have been studied in order to evaluate the tax system. Conclusions drawn from these evaluations are used to analyze the prospects of maintaining the level of tax revenue after further trade liberalization. Further, some potential effects of the tax reforms on the economy will be discussed. The study does not attempt to quantitatively estimate the future impact of the fiscal transition on government revenue. Instead it analyzes how the composition of tax revenue has changed and the potential effects of such changes on the economy. When evaluating the tax system and its reforms, a rather broad approach is taken in order to provide an overarching picture. The focal points in the analysis are those laid

⁵ Bureau of African Affairs: 2009

⁶ IMF PSI: 2009: p. 21

⁷ The tax system of Cape Verde does not entail export taxes.

⁸ Trade taxes include import tariffs.

out in the theoretical framework, which have been chosen since they are central in the theory of tax policy for development.

The focus of this study lies with the input side of the tax system, which entails the structure of tax rates and bases for taxation to raise money for the government. The output side, i.e. benefits financed by the government, although important, will not be analyzed further. Since they are proven to be the most important for tax revenue in Cape Verde, the income tax and value-added tax (VAT) will be central.

The empirical material for this study was collected during a two-month long field study in Praia, Cape Verde, and was obtained from both primary and secondary sources. The primary sources are interviews with people working in areas related to public finance or international relations.⁹ Secondary sources are documentation – such as research papers, government documents and statistics – provided by officials at relevant institutions. When carrying out interviews, there are methodological concerns to be aware of. Firstly, there is the language barrier implying a risk of misinterpretation. Secondly, data obtained from interviews may be affected by subjectivity. In order to minimize these risks, complementary material to the interviews has been used where possible.

The remainder of this paper is structured as follows. Chapter 2 presents theoretical aspects regarding tax policy in developing countries. Chapter 3 briefly describes the past and future trade liberalizing policies in Cape Verde and concludes with an analysis of how reforms have affected tariff revenue. Chapter 4 describes the recent tax reforms in Cape Verde, including domestic taxes as well as trade taxes, and their effects that have been observable in tax revenue. Chapter 5 attempts to evaluate these reforms, using the theoretical framework laid out in chapter 2. Finally, chapter 6 concludes and formulates some policy implications.

⁹ Consult the list of references for a complete declaration of consulted people.

2. Theoretical Framework – Tax Policy in Developing Countries

This section presents the theoretical framework which will function as an instrument when assessing the tax policy changes in Cape Verde.

2.1. General Notes on Taxation in Developing Countries

Tax revenue and tax policy are used to obtain national objectives. Normally, governments use tax revenue to provide the goods and services required to enhance economic growth and development, correct market failures, redistribute income and wealth and maintain macroeconomic stability. The latter is particularly important in small open economies which are highly dependent on the world economy. Such economies need fiscal space to buffer external shocks to the economy, which gives tax revenue a central role.¹⁰

How to design a tax system in a developing country, or in any country, is a complex matter that requires thorough consideration of the particular country of concern. Although there is no overall recipe for success, there are features linking developing countries together that may be used for the analysis of the actual and potential performance of their tax policy.¹¹

2.1.2. The informal sector

In developed countries, the personal income tax raises a large share of total tax revenue. In developing countries, however, it encounters serious difficulties as they are often characterized by large informal sectors. A large part of the labor force is employed in the agricultural sector or in small informal enterprises where incomes fluctuate and records are not accurately kept.¹² The relative size of this informal sector is often three or four times larger in developing countries than in developed

¹⁰ CF: IMF: 2009

¹¹ Bird: 1992: p. 19

¹² Tanzi et al: 2001

countries.¹³ Since ways of effectively taxing the informal transactions has not yet been found, the base for personal income tax is narrow in developing countries and levying high taxes on that base may enhance the existing distortions. The large informal sector, which also complicates the taxation on consumption, is one of the factors restricting the tax policy design of developing countries.¹⁴

2.1.3. Tax administration

In most developing countries, tax collection is heavily constrained by the shortcomings of tax administration. Customs duties are administratively simple and substituting such taxation for other domestic taxation challenges tax administration. Administrative efficiency is limited by the lack of resources and according to Bird; the administrative dimension should be placed at the center of tax reform efforts.¹⁵ In order for a tax reform to be successful, well designed policies need to be accompanied by effective implementation, which entails improving the tax administration. When analyzing the desired tax design of a developing country, one always needs to keep the administrative constraint in mind. As Tanzi & Zee put it; "...in developing countries, tax policy is often the art of the possible rather than the pursuit of the optimal".¹⁶

2.2. Efficiency

Efficiency is a fundamental characteristic of a functioning tax system. The efficiency losses resulting from taxation, as defined by Corden, can be categorized as follows:¹⁷

- The costs of tax administration
- The resource costs when taxpayers fulfill their tax obligations while minimizing payment or perhaps ensuring successful evasion

¹³ Bird et al: 2008: p. 7

¹⁴ Tanzi et al: 2001

¹⁵ Bird: 1992: p. 189

¹⁶ Tanzi et al: 2001

¹⁷ Corden: 1974: p. 65, cited from Balassa: 1989: p. 5

- Distortion-costs from taxpayers rearranging their affairs as a part of avoidance or evasion effort

The following two sections deal with all these efficiency aspects.

2.2.1. Simple tax design

To start with, due to the administrative constraint, minimizing costs of tax administration is vital in developing countries. In this context, the tax rate structure plays an important role. Since a system with various tax rates puts higher pressure on administration, developing countries in particular are advised to use a simple tax rate structure.¹⁸ A complex tax rate structure allows for tax avoidance and evasion to a greater extent than a simple one, unless ability to monitor transactions and ensure tax compliance is high. Since this is normally not the case in developing countries, reducing tax evasion is problematic and simplifying the tax rate is a recommended reform policy. Simplifying the tax design does not only entail the application of uniform tax rates but also the reduction of the number of exemptions and deductions.¹⁹

Simplifying the tax rate structure could also decrease costs of the second category, since a complex tax rate structure makes it difficult for taxpayers to be fully aware of their tax obligations and thereby increases the transaction costs incurred in fulfilling them.²⁰

The degree of complexity in the tax system also affects how taxpayers perceive it. Complexity lowers transparency and might reduce overall confidence in the system. One of the prerequisites for a functioning tax design is that policy objectives of the tax system are explicitly related to the instruments. As these links are less transparent, the general willingness to pay taxes may decrease and lower tax compliance.²¹

¹⁸ Theodossiadis: 2004: p. 25

¹⁹ Ibid

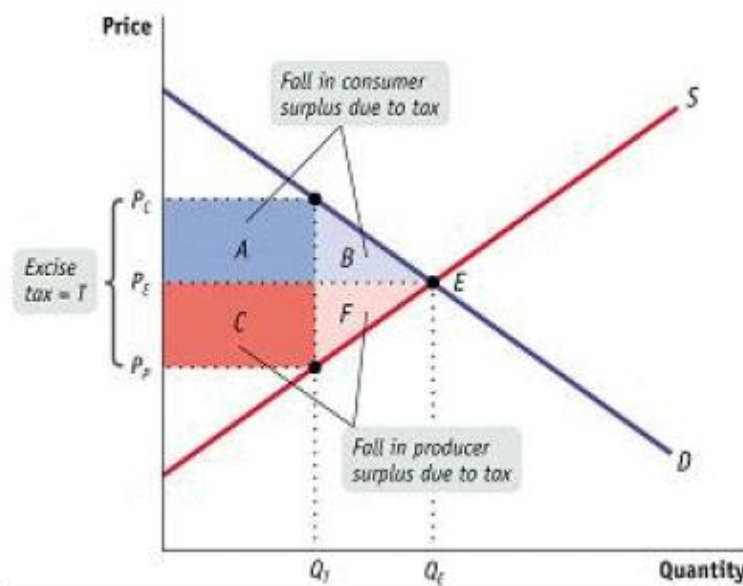
²⁰ Agell et al: 1996: p. 6

²¹ Bird: 1992: p. 17

2.2.2. Broad tax base

The third category of efficiency loss mentioned above is derived by using microeconomic tools to predict the effects of taxation on the behavior of individuals and enterprises. As taxpayers change their economic behavior to avoid or minimize taxes, distortions to the market forces in the economy are created. These distortions are captured in the so called deadweight loss, illustrated in figure 1.

Figure 1. Deadweight loss of a tax



Government revenue from tax:
 $A + C$
Deadweight loss: $B + F$

Source: Mankiw: 1998

The deadweight loss is the reduction in producer and consumer surpluses due to unrealized market exchanges. It occurs because economic actors let other factors than the pure market forces influence their economic behavior, which results in a less than optimal outcome. The taxes that are most efficient in raising revenue are those that minimize such deadweight loss by minimizing the behavioral responses. Such taxes are levied on behavioral patterns of low elasticity, such as consumption of goods covering basic needs.²² However, such a structure cannot be considered justifiable

²² Mankiw: 1998: p. 165

from an equity perspective since it hits the poor harder than the rich. Instead, distortions can be limited by using a broad tax base and low tax rates.²³ The size of the deadweight loss is determined by the elasticities of demand and supply as well as by the rate of the tax. Consulting the figure above, the deadweight loss is equal to triangle B+F. The tax rate is the base of this triangle, but since the rate of the tax also affects the change in consumption that the tax causes, it also affects the height of the triangle. Hence, the tax rate has a double effect on the area of the triangle, implying that it has an important impact on the deadweight loss.

When designing a tax system, there are four different tax bases that can be used. These are labor, consumption, capital and land. What impact the taxes have on the economy does, to some extent, depend on the relative importance given to each of these different tax bases. Their characteristics will be discussed throughout the following sections.

The two tax bases that normally generate most revenue are labor and consumption. When choosing between these two, microeconomic tools analyzing how taxes affect behavior are useful. As mentioned above, taxing labor is problematic in developing countries due to the size of the informal sector. When individuals and enterprises decide to operate in the informal sector, the decision relies on relative costs and benefits of working in the formal sector. Where the informal sector is considered a reasonable alternative, formal sector labor supply is elastic and should therefore preferably be taxed with caution.²⁴ Again, the administrative constraint plays an important role. Where ability to monitor transactions and taxpayers is perfect, informal sector activity can be reduced by penalties, but since such administrative capacity is lacking in most developing countries, the penalty instrument has limited effectiveness. This, added to the fact that a low per capita income implies that few individuals reach a taxable level of income, narrows the tax base for personal income taxation.²⁵

As mentioned, the informal sector narrows the tax base for consumption as well. However, when taxing consumption, there are more tools for limiting the informal transactions, see section 2.6.

²³ Theodossiadis: 2004: p. 22

²⁴ Bird et al: 2008: p. 7

²⁵ Ibid

In a developing economy seeking enhanced economic growth, investment is central. There is therefore a need to keep the cost of capital low, which reduces the possibility of taxing capital.²⁶ On the contrary, property is probably the most efficient tax base. Elasticity is low when it comes to land and buildings since they are not mobile, which makes it more complicated to avoid tax on property by changing behavior. These characteristics contribute to minimizing dead weight losses. However, the revenue generated by the property tax is limited. This since property is a basic need and the taxation of such needs has to be adjusted to people's ability to pay, thus preventing it from being excessive.²⁷

The conclusion that can be drawn from the reasoning above is that it seems advisable to reduce the reliance upon income and capital taxation for low-income countries. Land taxes are efficient but their revenue generation is limited in a poor economy. Consumption taxes seem to be a better way of broadening the tax base and achieving higher efficiency.

With an efficient tax system, economic growth should be reflected in tax revenue. The so called GDP-elasticity of a tax system shows the growth of tax revenue in relation to the growth of GDP. An efficient system has a GDP-elasticity at or above one, meaning tax revenue grows at least at the same pace as GDP.²⁸

2.3. Equity

The equity concept is, like efficiency, considered fundamental in tax policy analysis. It consists of horizontal and vertical equity and contains normative elements based on value judgments regarding fairness. In this context, horizontal equity refers to the tax system's ability to treat individuals of the same income group equally. The vertical equity perspective refers to a tax systems' ability to redistribute wealth in order to reduce income disparities.²⁹

²⁶ Tanzi et al: 2001

²⁷ Ibid

²⁸ Birt et al: 2007: p. 59

²⁹ Bird: 1992: p. 13

The personal income tax is perceived by some as the most “fair” taxation since it has the potential of taxing individuals based on their ability to pay.³⁰ Although its function is limited in developing countries, its strengths are important to point out since they may have policy implications as the economy develops.

When striving for equity, exemptions and deductions, which are common features of tax systems in developing countries, should be used moderately. This will be discussed further in the following section, as will the vertical equity perspective.

2.4. Growth, Redistribution and Poverty

For any developing country, enhancing economic growth is a central policy objective. The tax structure therefore needs to promote development of industry and the private sector, and should not discourage economic activity.³¹ In economic growth theory, investment is the central factor of the growth function.³² Since a tax on capital reduces the rate of return on investment, it might distort investment decisions. Corporate taxes therefore need to be structured accordingly, encouraging investment by reducing distortions and promoting its profitability.³³ Fiscal incentives – tax exemptions and deductions structured in a way that is preferential to the investor – are instruments used by many countries to promote investment. Using tax incentives may not be as effective as desired, though. Their revenue costs may be high, in part because they complicate the administrative process and in part due to the risk of enterprises abusing them. Nevertheless, when investment involves positive externalities on the economy, there may be reason for using tax incentives, provided that they are effective and well-targeted.³⁴

The general idea of growth-enhancing taxation is that the ones with ability to save should be taxed lightly in order to promote investment.³⁵ Given that the rich save more than the poor because they have the chance of receiving profits, taxing the rich may reduce growth and the redistributive tax system is sometimes seen as a luxury that

³⁰ Bird: 1992: p. 85

³¹ Tanzi et al: 2001

³² Bird: 1992: p. 41

³³ Tanzi et al: 2001

³⁴ Ibid

³⁵ Bird: 1992: p. 41

poor countries can ill afford.³⁶ However, within growth theory there are also statements conflicting this. Studies have shown that the poor have a higher marginal propensity to save, which means that a redistributive tax system could enhance saving.³⁷

Redistribution can also be attractive from a growth perspective as there are growth theories describing a negative relation between inequality and growth, e.g. stemming from the view that equality is essential to the political stability required for sustained growth.³⁸ Hence, redistribution may be a tax policy objective not only in high-income countries but also in developing ones, and it is therefore of importance to consider the effects on income distribution when evaluating tax reforms.

So how is a redistributive tax system achieved? In this discussion, the level of progressiveness in the tax design is central. The easiest way to obtain progressiveness in the tax system is by diversifying the income tax rate structure. This is also a visible policy instrument that the government can use to prove its dedication to social justice, which makes it attractive.³⁹ However, nominal progressiveness brings about efficiency losses due to the administrative complexity and behavioral responses discussed above. Consumption taxes, on the other hand, are viewed as regressive in development literature since they constitute a larger share of income at lower levels of income. Exemptions in the taxation of goods considered essential are therefore often recommended in order to avoid heavy tax pressure on the poor.⁴⁰ However, exempting essential goods is not a very effective way of redistributing income. Although high-income earners consume fewer essential goods relative to their income, they are likely to consume more in absolute terms, meaning that they benefit more than the poor from the exemptions. Further, the exemptions differentiate the rates of the VAT, which causes efficiency losses. Some literature suggests that the equity gains from exempting essential goods are unlikely to offset the efficiency losses.⁴¹ Instead, direct transfers to the poor may be more effective instruments for redistribution of income. For many

³⁶ Ibid

³⁷ Ibid

³⁸ Bird: 1992: p. 43

³⁹ Tanzi et al: 2001

⁴⁰ Bird: 1992: p. 52

⁴¹ Bird et al: 2007: p. 110

developing countries, however, these instruments are difficult to use because of the information and capacity they require from the public sector.⁴²

Some development literature suggests excise taxes on “luxury” goods in order to make the consumption tax progressive. This is however associated with the efficiency losses related to complex tax rate structures. Determining the rate structure of such excise taxes also entails making some judgments regarding the consumption patterns of individuals, which could be complicated and result in individuals with the same incomes being treated very differently.⁴³ Moreover, it is important to keep in mind that the effects of excise taxes may be difficult to predict. The tax incidence does not always fall on the payer indicated by the tax design, since the tax may affect many decisions that in turn affect other parts of the economy than was intended when introducing the tax. Even if the excise tax is well targeted so that the “luxury” goods are exclusively consumed by the rich, its burden may rest elsewhere. If demand for the “luxury” good in question is price elastic, the tax may lead to decreased consumption of the good, which affects the producer and supplier. If the producer or supplier is not wealthy, the tax does not end up being as progressive as intended.⁴⁴

All the above are ways in which the tax design may affect the system’s redistributive ability. However, the degree of redistribution does not only depend on the tax design, but also on the benefits financed by tax revenue. How the benefits are distributed and whether the poor receive them at all may be more important considerations than how much they have to pay for them.⁴⁵ However, having mentioned that, this paper focuses on tax design and leaves public spending out.

As a final note on taxation and growth, one should also keep in mind that the growth in several developing countries today has become influenced by globalization and economic integration. Where foreign direct investment (FDI) serves as an important growth engine, the domestic tax system is a commonly used instrument to attract foreign investors. Many countries grant fiscal incentives to foreign investors.⁴⁶ Economic integration also brings about so called tax competition, induced by the

⁴² Bird: 1992: p. 49-50

⁴³ Ibid: p. 59

⁴⁴ Mankiw: 1998: p. 259

⁴⁵ Bird: 1992: p. 56

⁴⁶ Tanzi et al: 2001

increasing mobility of capital and labor, limiting a country's ability to choose a tax design that differs too much from its neighbors'.

2.5. Fiscal Federalism

The fiscal structure is another important aspect of a tax system. Depending on the degree of decentralization, different tax revenues accrue to different levels of government. Fiscal activity in the municipalities is financed either by tax revenue being transferred from the central government to the lower levels of government, or by tax revenue that accrue directly to the lower levels of government. Which of these two structures is aimed at may affect which tax design is desirable. For example, whether the central government receives a larger share of tax revenue from income taxes than those from consumption taxes, as found common in a study by Rajaraman⁴⁷, may affect its attitude towards a reform that shifts reliance towards consumption taxes. Since taxes on trade are always levied by the central government, while income or consumption taxes may be governed by other levels of government, the central government may have such considerations regarding tax reforms as a consequence of trade liberalization shifting reliance from trade taxes to domestic taxes.⁴⁸

2.6. The VAT

The type of consumption tax which has proved to be most successful in raising revenue is the value-added tax (VAT), which is a broad-based tax levied at multiple stages of production. It has become the most important single tax in many developing countries and is preferred over sales and turnover taxes since it ensures tax collection throughout the production process without distorting production decisions. This is accomplished through a refund system crediting taxes on inputs against taxes on output.⁴⁹ Consumption taxes do not solve the problem of informal sectors but since the VAT is levied on several stages of production, the probability of some of the informal

⁴⁷ Rajaraman: 2004: p. 11

⁴⁸ Ibid: p. 10

⁴⁹ Bird et al: 2007: p. 10

transactions being captured in tax revenue is greater than when using other consumption taxes.⁵⁰ All operators who purchase their inputs from the formal sector or from other countries pay VAT on these inputs, even if he or she is not registered for the VAT. If the operator is registered, the VAT paid on inputs will be refunded, but if he or she operates in the informal sector and is not registered for the VAT, the amount already paid will not be refunded. This means that as long as the informal operators purchase some of their inputs from the formal sector or from other countries, they carry the VAT burden.⁵¹ This reduces the informal transactions and should provide some of the informal operators with incentives to register for the VAT and operate in the formal sector.

Nonetheless, the structure of the VAT entails some problems as well. High compliance costs for small firms and the vulnerability of the refund system to fraud are some of the important weaknesses of the tax. As the fiscal weight put on this tax has increased in recent years, these problems have been worsened.⁵²

In general, less developed countries are advised to apply a uniform rate on all goods and services in order to reduce administrative complexity. Exemptions for goods considered as basic needs are recommended as a means of avoiding a heavy burden on the poor, although it creates distortions and efficiency losses. The system should also ensure full right to credit on all taxes paid on inputs when a good is exported. Since exports are not taxed, this is a means of treating them the same as imports and not discouraging exports.⁵³

Further, the evolution of a functioning financial system is important in a developing economy. Hence, minimizing their costs and distortions, leaving financial services untaxed may be the best option. Further, financial services are so complicated to tax that many countries, developing ones in particular, have to exempt them.⁵⁴

⁵⁰ Bird et al: 2007: p. 79

⁵¹ Keen: 2007: p. 12-14

⁵² Bird et al: 2007: p. 20, Keen: 2007: p. 15

⁵³ Bird et al: 2007: p. 108

⁵⁴ Ibid: p. 98

2.6. Tax Reform in the Context of Trade Liberalization

Liberalizing trade and reforming the domestic tax system in order to recover the resulting government revenue loss could be a growth-enhancing process if carried out successfully. Trade theory tells us that trade liberalization leads to increased GDP and trade flows, which raises welfare through increased consumption opportunities. If the tax system is efficient enough, tax revenue grows in the same proportion and captures the gains from trade in the state budget. Generally, developing countries are advised to substitute their import duties with indirect taxes.⁵⁵ As the tariff elimination leads to lower import prices, provided that there is competition keeping the producer from maintaining a higher price level, a commodity tax can be added without making the consumer worse off.⁵⁶ Moreover, overall domestic consumption is broader than imports, implying that a shift from trade taxes to consumption taxes on substantially all commodities broadens the tax base and enhances horizontal equity in the system.⁵⁷

Apart from raising government revenue, tariffs are also used to protect domestic production. Liberalizing trade implies exposing domestic production to higher competition, putting higher pressure on efficiency in production, which may be threatening to some sectors. Hence, the degree to which the economy is affected by the liberalization depends on the extent to which the trade barriers serve as protectionism. However, even when domestic production is not threatened by trade liberalization, a reform of the kind described above may shift taxation from some commodities to others, implying some difference to taxpayers. The importance of this difference depends on consumption patterns related to import patterns.

As described, the need of domestic tax reform in the context of trade liberalization is a result of tariff revenue being reduced. As tariffs are eliminated, revenue has to be collected from other sources. However, when tariffs are not eliminated but reduced, some of the resulting fiscal impact may be offset by an

⁵⁵ For instance, see Bird et al: 2007: p. 20

⁵⁶ Baunsgaard et al: 2005: p. 3

⁵⁷ Ibid

increase in imports.⁵⁸ Even the revenue loss from an elimination of tariffs can be offset by the increase in imports when a VAT is levied on the import good and the increased import flow hence increases VAT revenue. This reasoning stems from the general assumption of trade liberalization leading to increased trade volumes. This assumption is in turn based on the assumption that tariff reductions lead to price reductions, boosting domestic demand for import goods.⁵⁹ It should be noted that in order for this to be true, the import goods need to be somewhat price elastic. Moreover, one should keep in mind that lacking competition could hinder the tariff reductions from turning into price reductions; such market failure may allow companies to increase profits instead of lowering prices. In the cases where insufficient competition allows the import price reduction to accrue to the companies in the shape of profits, consumption is left unchanged and hence, so is VAT revenue. However, if the taxation is effective enough, the enterprises' increased profits could contribute to an increase in revenue from the corporate income tax, reducing the revenue loss.⁶⁰

Hence, the degree and character of the trade liberalization in question determine the need of domestic tax reform.

⁵⁸ Hallaert: 2008: p. 5

⁵⁹ Ibid

⁶⁰ Ferreira et al: 2006: p. 71

3. Trade Liberalization in Cape Verde

This chapter briefly describes the trade liberalizing reforms that have had and will have the largest impact on government tariff revenue. It also discusses in what way tariff revenue has been and will be affected by these reforms.

3.1. The Economy of Cape Verde

As mentioned in the introduction, Cape Verde is a small economy. The number of inhabitants is estimated to approximately 430,000 and the GDP to 2,300 billion US dollars (2008 est.).⁶¹ The country is a former Portuguese colony that gained independence in 1975. It has experienced rapid growth in recent years, averaging 6 to 7 per cent. In 2009, the growth held up at 4 per cent in spite of the global financial crisis.⁶² The high economic growth rate mainly reflects the high growth in the tourism sector – Cape Verde’s main source of income.

In 2008, Cape Verde joined the WTO and graduated from the UN least-developed-country (LDC) status. Along with the benefits associated with this, the graduation will also imply challenges as the country needs to become less dependent on aid. Under the support of IMF’s Policy Support Instrument (PSI), Cape Verde, among other things, is aiming at reducing the government’s domestic debt ratio and creating fiscal space in order to offset possible declines in external financing due to the graduation from LDC status.⁶³

Cape Verde is a country of poor natural resources, which makes its production limited. Unemployment is high, some 18 per cent in 2008.⁶⁴ Historically limited production possibilities worsened by cycles of drought force many people to migrate and the expatriate population is now greater than the domestic one. The country has long been dependent on foreign aid and remittances from Cape Verdeans resident

⁶¹ Bureau of African Affairs: 2009

⁶² IMF PSI: 2009: p. 2

⁶³ IMF: 2007

⁶⁴ TradeCom Facility: 2008: p. 19

The table shows that the EPAs may have a great impact on Cape Verde's public finance, making the subject of reforming the domestic tax system in order to recover for the revenue loss highly critical. At this time, however, the constitution of the EPA has yet not been established as negotiations are still taking place between the parties involved. At this stage, predictions of its impact on the Cape Verdean economy are therefore speculations. The impact will depend on which tariffs are lowered and the different elasticities of domestic demand with regard to price. If the import goods are price-elastic, the price reduction resulting from lowered tariffs will lead to increased imports, which may keep tariff revenue more or less unchanged. In recent years, tariffs have been cut and customs general fees have been abolished but the level of revenue from trade taxes has yet been kept fairly stable, as a result of the increase in imports.⁶⁸

The EPA-negotiations are not carried out on an individual level but with the West African ECOWAS-countries, plus Mauritania, as a group. These are therefore at the moment negotiating a common external tariff to be applied. In this process, the countries are elaborating a list of sensitive products that need to be liberalized with a longer time span, or not at all. In determining the sensitivity of products, their contribution to tariff revenue is one of four parameters that are considered. The list will constitute a starting point for negotiations with the EU.⁶⁹

3.3. Implemented Trade-Liberalizing Policies

Starting in 2003, the structure of import taxes of Cape Verde has undergone important reforms. A main objective of these reforms has been to simplify the legislation but there were also requirements of change in the tariff structure imposed by the WTO accession.⁷⁰ In the pre-reform structure, the customs taxation consisted of three taxes – tariffs, customs general fees and the Consumption Tax. Reforms included the abolishment of general customs fees and the Consumption Tax as well as significant simplifications of the structure of tariffs. These reforms will be described further in chapter 4.

⁶⁸ IMF PSI: 2009

⁶⁹ Figueiredo: 2009-05-20

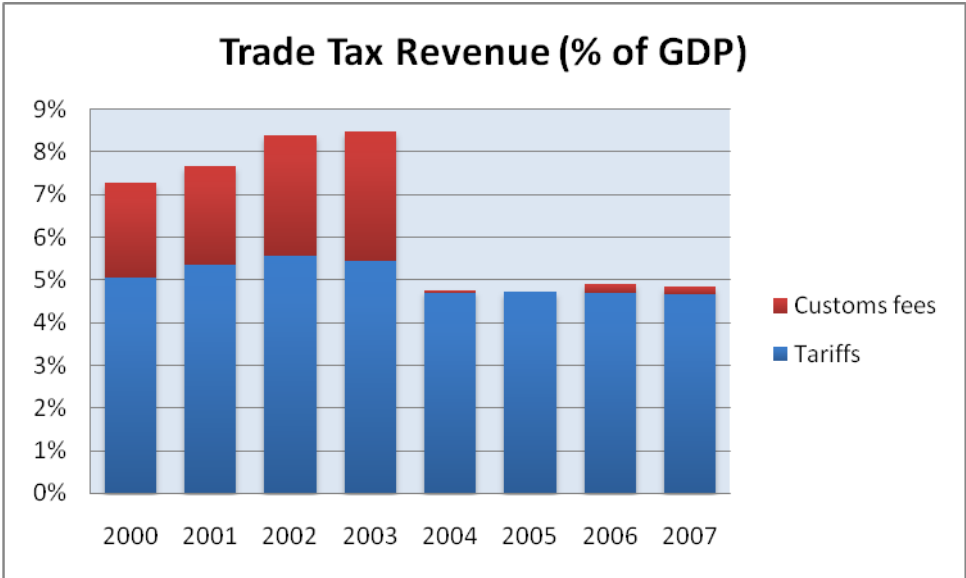
⁷⁰ Ibid

Since the reforms of the customs of Cape Verde, the trade-weighted average tariff rate has been lowered significantly.⁷¹ In 1995, it was approximately 24 per cent and by 2002 it had risen to 31 per cent. In 2004, with the introduction of the VAT and the abolishment of general customs fees, it dropped to 12 per cent. This rate is lower than LDC-members but higher than recently acceded developing countries in the WTO.⁷²

3.4. Impact of Trade Liberalization on Tariff Revenue

Revenue from taxes on international trade has increased from 63.5 million USD in 2000 to 75.7 million USD in 2007.⁷³ Between 2003 and 2004, it dropped by 42 per cent as a result of the abolishment of customs general fees but after 2004, the increasing import volumes contributed to rising tariff revenue.⁷⁴ However, as a share of GDP, total revenue from trade taxes has declined significantly.

Figure 2. Trade tax revenue as share of GDP, 2000-2007



Note: Own calculations. Source of data: BCV

⁷¹The trade-weighted average tariff is the average of tariffs weighted by value of imports; total tariff revenue / total value of imports.

⁷² TradeCom Facility: 2008: p. 1

⁷³ Currency converted at current rate: 2010-01-11.

⁷⁴ BCV

Figure 2 shows the evolution of the revenue from taxes on international trade, broken down into general customs fees and tariff revenue. As a share of GDP, revenue from trade taxes declined from 7.3 per cent in 2000 to 4.9 per cent in 2007.⁷⁵ The decline mainly reflects the drop caused by the abolishment of customs general fees.

Studying the evolution of revenue from tariffs alone, the decline is less significant. In 2000, tariff revenue accounted for 5 per cent of GDP and in 2007, the corresponding share was 4.7 per cent. The most important drop occurred in 2004, when the share of tariff revenue in GDP declined 0.75 per cent compared to the previous year.⁷⁶

As mentioned, trade liberalizing measures such as tariff or customs duties reductions do not necessarily imply a corresponding trade tax revenue loss. According to Carlos Figueiredo, of the Directorate of Studies and International Relations at the Cape Verdean customs, WTO experience tells them that, in most cases, tariff revenue does not decrease because of tariff or fee reductions, in part because these lead to increased import volumes if the import goods are price elastic, but also because lower rates reduce incentives to evade paying tariffs by committing fraud or demand exemptions.⁷⁷

Whether imports increase as a result of tariff reductions is not only a matter of price elasticity of the imported good. Where competition is lacking, chances are that the price is not affected by the tariff reduction; if prices are not affected, neither are imports. According to Figueiredo, a number of the tariffs that were reduced in 2004 were not followed by price reductions, due to lack of competition.⁷⁸ Whether this will be the case in future tariff reductions depends on too many factors to be analyzed here. What can be said is that imports in Cape Verde have increased after the past tariff reductions and the abolishment of customs general fees. However, this is not necessarily because the measures have been followed by price reductions. The overall economy grew notably in the same time period, which implies that domestic demand increased. This is also a probable cause of the growing import volumes.

⁷⁵ BCV

⁷⁶ Ibid

⁷⁷ Figueiredo, 2009-05-20

⁷⁸ Ibid

To sum up, the expected effect of tariff and fee reductions on tariff revenue is not definite. In the case of Cape Verde, total revenue from taxes on international trade has declined notably, meaning that other ways of raising revenue have been needed. When it comes to tariff revenue alone, it can be concluded that although the trade liberalizing processes have reduced tariffs, tariff revenue has remained at a constant level due to increased import. However, the liberalization of trade cannot be isolated as a cause of the increased demand for imports so the same development cannot be counted on for future trade liberalization. Considering that the EU is by far the most important trading partner of Cape Verde, studies predict that the final result of the EPA will be an important revenue loss. Whether this revenue loss can be recovered depends on the efficiency and capacity of the domestic tax system and administration.

4. Tax Policy in Cape Verde

This chapter describes the reforms that have been implemented in the Cape Verdean tax system to date and their objectives, as well as gives an overview of the current tax design. The concluding section of the chapter analyzes the effects of these reforms on tax revenue.

4.1. The Public Sector

Cape Verde has a history of a relatively large public sector. Total public expenditure accounted for 31.5 per cent of GDP in 2007. Of these expenditures, 32 per cent were investments and 7 per cent were transfers to families in the shape of pensions and subsidies.⁷⁹ As a result of the global financial crisis, the public investment program, with a main focus on infrastructure, has been expanded in order to support economic activity.⁸⁰ Public services, including education and health care reached 13 per cent of GDP the same year.⁸¹ Since 2002, public debt has shrunk and the state budget has been balanced, as revenue has increased while expenditure has decreased as shares of GDP.⁸²

The fiscal system of Cape Verde dates back to 1901 when it was first defined by the Portuguese to enable a budget for the country. It then evolved successively during the century, but in the beginning of the nineties it was still based on the administrative regulation created in 1901. Both the design and the administration were out of date in the sense that they were not contemplated for the evolving market economy and thereby constrained the system's ability to produce revenue effectively. Since 1992, the system has therefore undergone major reforms. The reforms entailed both direct and indirect taxes.⁸³

⁷⁹ BCV

⁸⁰ IMF PSI: 2009: p. 26

⁸¹ INE: 2007

⁸² BCV

⁸³ Moreira: 2009-05-29

4.2. Indirect and trade taxes

Before reforms, the structure of indirect taxes consisted of various taxes, of which the import tariff and the consumption tax were the most important. There were 64 different rates in the structure of import taxes varying from 0 to 328 per cent of CIF⁸⁴ value and a large number of exemptions. The complexity led to similar goods being treated very differently in some cases, resulting in distortions and unfair treatment of taxpayers. Moreover, goods used as input in domestic industry were at times taxed higher than the final product, further distorting economic decisions by creating disincentives for domestic production.⁸⁵

The Consumption Tax in the pre-reform system treated imported goods differently from domestically produced goods, which made it function more as a tariff than a regular consumption tax. It had various applied rates, of which some were elevated, which complicated administration, hindered international trade and created incentives for fraud and fiscal evasion.⁸⁶

One of the most important weaknesses of the pre-reform tax design was the narrow tax base. Regarding the indirect taxes, one of the problems was that the Consumption Tax was only levied at one stage of production, letting the value created in the activities by retail and wholesale dealers escape taxation. Further, services were untaxed, which leaves out a great potential source of tax revenue as well as creates inequity.⁸⁷

4.2.1. Structure of Import Taxes – *Pauta Aduaneira*

The structure of import taxes was reformed with the objective of making it simpler, more transparent, with lower rates and with justified differentiation.

⁸⁴ The Cost, Insurance and Freight Value represents the landed value of the imported good at the first port of arrival.

⁸⁵ MF: 2002: p. 2

⁸⁶ Ibid

⁸⁷ Ibid

Firstly, anomalies of the structure of import taxes were eliminated and customs duties were reduced to only containing tariffs, eliminating the customs general fees.⁸⁸ Rates were reduced, in part as a result of commitments related to the WTO-accession and in part in order to reduce distortions and fiscal evasion incentives. In order to simplify and rationalize, the number of rates was lowered from 64 to 7, and the maximum rate was reduced from 328 per cent to 50 per cent. Exemptions meant to create incentives for investments were also reduced at the same time as the tax rates on primary material and capital goods were lowered by a substantial percentage.⁸⁹

The Consumption Tax was eliminated in 2004.⁹⁰

4.2.2. The Special Consumption Tax – *Imposto sobre o Consumo Especial*

The Consumption Tax mentioned above was substituted by the VAT and the Special Consumption Tax (ICE). This was a measure of broadening the tax base, reducing incentives of fraud and evasion and increasing collection efficiency. The Special Consumption Tax is structured in a way that makes the selective taxation more specifically targeted than it was before reforms. It is levied on a small number of goods considered to be either of superfluous nature or destructive for the health of the population, in an attempt to make the indirect tax system somewhat progressive and to fiscally penalize harmful consumption. Some examples of goods subject to the tax are alcohol, tobacco, cosmetics and old cars.⁹¹

The Special Consumption Tax did not only replace the Consumption Tax, but also other targeted consumption taxes, of which the most important were the Petroleum Tax and the Special Tax on Alcohol and Tobacco.⁹²

4.2.3. The VAT – *Imposto sobre o Valor Acrescentado*

The perhaps most important part of reforms was the introduction of the VAT. It took place in 2004 and the VAT rapidly became the single most important source of tax

⁸⁸ The customs general fees were levied on imports as a fixed percentage of the import value.

⁸⁹ MF: 2002: p. 32

⁹⁰ Ibid

⁹¹ Moreira: 2009-04-30, MF: 2002: p. 32

⁹² BCV

revenue. In many ways, its design matches the recommendations described in the theoretical framework. With some exceptions, it is levied on all goods and services at a uniform rate of 15 per cent, imported as well as domestically produced. Essential goods such as milk, vegetables, fruit and meat are exempt, as are medication, banking services and equipment and inputs for agriculture. Exports are also exempt from the VAT through a mechanism that gives producers of export goods full rights to credit on taxes paid on inputs. Goods and services related to hotel and restaurant business are taxed at the rate of 6 per cent.⁹³

With the introduction of the VAT, the structure of indirect taxes was considerably simplified. It substituted 10 different taxes such as the Consumption Tax, the Tax on Oil Products, the Special Tax on Consumption of Alcohol and Tobacco and the Tourism Tax.

The structure of the VAT entails special conditions, not only for hotels and restaurants, but also for smaller companies. The normal VAT rate of 15 per cent applies to companies with a turnover above 68,000 USD and organized bookkeeping that allows them to declare their liquidated and collected VAT on a monthly basis. Companies whose income⁹⁴ did not exceed 2,400 USD the previous year, on the other hand, are granted full exemption from the VAT. Companies that do not qualify for the VAT exemption but have a turnover below 68,000 USD are granted what is called a simplified regime for which the VAT does not function as a value-added tax but rather as a sales tax.⁹⁵ The taxpayers declare on a quarterly basis and instead of declaring both liquidated and collected VAT, they declare only the value of their sales. Of this value, a tax at a rate of 5 per cent is collected. The taxpayers that qualify for exemption or the simplified regime have no right to deduction of the VAT they paid in earlier stages of production. Taxpayers in this regime are allowed to move over to the normal regime if they wish to.⁹⁶ These regimes were created as a means of limiting evasion and finding a way of taxing the companies without proper bookkeeping, as well as an attempt to ease the tax burden on smaller companies to promote their

⁹³ CRTD: 2004: p. 119

⁹⁴ Income is here defined as the income that serves as base for the single income tax.

⁹⁵ Currency converted at current rate: 2010-01-11.

⁹⁶ Varsano et al: 2009: p. 36

existence. The normal regime requires companies to keep a record of all transactions and preferably have a bank account and as it became obvious that the majority of the Cape Verdean companies do not fulfill these requirements, the simplified regime, requiring less in terms of bookkeeping, was created.⁹⁷ 75 per cent of all VAT-payers are under exemption or contribute according to the simplified regime.⁹⁸ In revenue statistics, the revenue from these simplified regimes count as VAT revenue.

4.3. Direct taxes

4.3.1. The Single Income Tax – *Imposto Único sobre o Rendimento*

The Single Income Tax was introduced in 1996 and consists of two separate taxes: the *Pessoas Singulares* levied on personal income and *Pessoas Coletivas* for corporate income. In this paper, these taxes will be referred to as the personal income tax and the corporate income tax when discussed separately, and the Single Income Tax when discussed as one. One should note that the personal income in this case entails income from labor, property and capital but also income from commercial activities which are carried out individually. Micro-companies employing less than five people are counted as singular persons, declaring their income as personal income, and are referred to as individual companies.⁹⁹

Since its introduction, the Single Income Tax has undergone various reforms which have consistently lowered the rates for both taxes. The personal income tax is progressive, applying differentiated rates to 5 brackets.¹⁰⁰ Reforms have made its design less progressive, lowering the rate of the top bracket from 45 per cent to 35 per cent in the budget for 2009.¹⁰¹ The corporate income tax was lowered from 35 per cent to 30 per cent in 2003 and the budget for 2009 lowered it further to 25 per cent.¹⁰² The objective of these recurring, rate-reducing reforms has mainly been to boost economic activity in different ways. Firstly, reducing rates has been a means of promoting savings and thereby investment. High-income earners are considered to be the ones

⁹⁷ Moreira: 2009-05-29

⁹⁸ Varsano et al: 2009: p. 35

⁹⁹ DGCI: 2007: p. 1

¹⁰⁰ Ibid

¹⁰¹ Boletim Oficial 2008: p. 4

¹⁰² Moreira: 2009-04-30, budget of 2009: p. 4

with the highest ability to save and since they were facing a rather elevated income tax rate, this measure was given priority. The corporate income tax has also been lowered several times in order to simplify doing business and make Cape Verdean companies competitive.¹⁰³

Reforms also extended exemptions and deductible expenses taking the taxpayer's family situation into account and increased the level of income regarded as subsistence level.¹⁰⁴

Like the VAT, the Single Income Tax has a simplified method of payment. This regime regards only the personal income tax. Persons or companies, employing fewer than five people and carrying out commercial activities with a turnover of less than 68,000 USD, pay the Single Income Tax, according to this regime called the estimative regime, which estimates the taxable income according to a certain model and applies a tax rate of 15 per cent.¹⁰⁵ Two thirds of the taxpayers who pay the Single Income Tax do so according to the estimative regime.¹⁰⁶

4.3.2. The Single Property Tax – *Imposto Único sobre o Patrimônio*

Another important direct tax is the property tax, in the Cape Verdean system named the Single Property Tax. It was introduced in 1998, substituting three different property taxes. It is collected by the municipalities and its revenue accrues to the municipalities' budgets. All municipalities apply the same rate of 3% of the value of the property. All owners of property pay this tax, including foreigners.¹⁰⁷

4.4. Other taxes

Although not central to this study, it is worth mentioning that a number of other, smaller taxes were included in the reforms. The two most important of these are the Stamp Tax, *Imposto de Selo*, levied on certain transactions, and the Environmental

¹⁰³ Moreira: 2009-04-30

¹⁰⁴ DGCI: 2007: p. 1

¹⁰⁵ Varsano et al: 2009: p. 36, Boletim Oficial 2008: p. 4

¹⁰⁶ Varsano et al: 2009: p. 35

¹⁰⁷ Moreira: 2005: p. 2

Tax, *Taxa Ecológica*, levied on imported goods that are considered harmful to the environment.

4.5. Administration

The tax authorities and the whole fiscal administration in Cape Verde have undergone important reforms and have been significantly improved in terms of efficiency. Reforms have included improvements in digitalization, supervision and inspection, transparency and taxpayer support. Since 1994, large parts of the government administration have been computerized. A few years ago, the government introduced an informatics system called SIGOF, Integrated System of Financial Budgetary Management, where all government transactions, contracts and status of different economic activities, are registered. Officials have access to the system and may consult it to determine what stage a certain operation, e.g. a purchase, is at. According to Claudino Semedo, General Director of the State Budget at the Ministry of Finance, this system has improved the state administrative efficiency immensely since it reduces manual paper work, facilitates communication between government departments and decentralizes administration. At the moment, the last step in all transactions – the payment – is in the hands of the Ministry of Finance but plans are to decentralize the whole process by moving the last step to the responsible department.¹⁰⁸ The applications mainly used by the tax authorities were developed in 2007 and 2008 and contain, among other things, modules of revenue and a VAT module. The goal is to reorganize and digitalize all tax collection processes in order to facilitate analysis of companies' bookkeeping. With this system, every official can consult the solicited documents and carry out analyses. This facilitates the work that is done after tax declaration.¹⁰⁹ The digitalization is also a step towards making online declaration possible. At the moment, companies can declare online, after a recent reform, but this is yet not possible for individuals.¹¹⁰

¹⁰⁸ Semedo: 2009-05-18

¹⁰⁹ Moreira: 2009-05-29

¹¹⁰ Ibid

In 2004, the government introduced a new Fiscal Identification Number.¹¹¹ This number is given to all individuals and companies and facilitates registration and tax collection significantly. Before this, the tax authorities' taxpayer database contained various weaknesses and one single taxpayer could have various identification numbers, sometimes leading to double or triple taxation.¹¹²

Before the reforms, the tax authorities lacked coordination and contracts with financial institutions. Taxes were collected by different institutions and the authorities failed in maintaining control over payments, resulting in time-consuming procedures and requiring of double payment at times. Added to this, the high bank commissions made depositing revenue in the bank very expensive for the tax authorities. Therefore, in the process of improving tax administration, contracts have been established with national banks, making it possible for tax authorities to deposit the collected revenue in a current account at a lower cost, thereby facilitating coordination and control.¹¹³

In addition to the technological improvements, the fiscal administration has put some effort into increasing both information and control. The government's webpage on the internet contains a great deal of useful information for the taxpayers regarding both legislation and declaration. Resources have been directed at making the internet more accessible for the people; there is now, for example, a free wireless network in several squares in the bigger cities. However, an important share of the households still do not have access to the internet and, in order to reach as many taxpayers as possible, information is also being distributed via brochures, television advertisements and through a radio program created by the tax authorities and broadcasted once a week. The objective of these projects is to inform the public of their tax compliance responsibilities and the government's policy objectives in order to decrease fiscal evasion.¹¹⁴

When it comes to controlling tax compliance, the tax authorities' capabilities have been improved not only through the technological progress but also through more efficient inspections. They now collaborate with the General Inspection of Economic

¹¹¹ MF: 2005: p. 2

¹¹² Moreira: 2009-05-29

¹¹³ Ibid

¹¹⁴ Ibid

Activities (IGAE), an authority within the Ministry of Economy, Growth and Competitiveness (MECC), that carries out inspections of economic activities. Their main areas are health and economic issues, but since they already carry out inspections, they collaborate with the tax authorities and control fiscal compliance as well in order to save resources and improve efficiency.¹¹⁵ Moreover, the government has introduced a special unit dealing with large taxpayers in order to maintain control of compliance of the most important sources of revenue.¹¹⁶

Box 1. Summary of implemented tax design reforms

Implemented Reforms

- Direct taxes:
 - Introduction of the Single Income Tax
 - Introduction of the Single Property Tax
- Indirect taxes:
 - Introduction of the VAT
 - Introduction of the Special Consumption Tax
 - Elimination of a number of taxes, such as the Consumption Tax, Petroleum Tax and the Special Tax on Alcohol.
- Trade taxes:
 - Elimination of customs general fees
 - Reduction of tariff rates; reduction of number of tariff rates from 64 to 7; reduction of maximum tariff rate from 328 to 50 per cent.

¹¹⁵ Vieira: 2009-05-27

¹¹⁶ Moreira: 2009-05-29

4.6. Current Tax Design

Table 2. Summary of current tax design; the largest taxes.

Tax	Exemptions and deductions	Rate
Direct taxes		
Single Personal Income Tax (IUR – PS)	- Income < 1 990 yearly. ¹¹⁷ - Income < defined subsistence level, taking civil status into consideration. - Some family-related expenses.	15-35%
Single Corporate Income Tax (IUR – PC)	Small sized companies in fishing, tourism, civil construction.	10–25%
Single Property Tax (IUP) (Municipal)		3 %
Indirect taxes		
VAT (IVA)	Essential goods, health services, agriculture, fishing, education, insurance and banking services.	General: 15 % Hotel and restaurant services: 6 %
Special Consumption Tax (ICE)	Only levied on “luxury goods” and unhealthy goods.	10 % (except cars older than 4 years: 30-150 %)
Trade taxes		
Customs duties – Tariffs	Primary goods, essential goods with no domestic production.	0-50 %

Source: DGCI: 2007, IMF: 2009, Boletim Oficial: 2008

4.6.2. Fiscal incentives

The current tax structure in Cape Verde entails some heavy tax deductions with the objective to promote investment and economic activity in certain areas. Tourism has been appointed the major growth engine of the economy and is therefore the main receiver of benefits. All goods and services related to hotel and restaurant activity are

¹¹⁷ Currency converted at current rate: 2010-01-21

given a VAT rate of 6 per cent. When introduced, the VAT was a flat rate for all sectors but pressure was high to make exceptions for tourist related ones. The argumentation in favor of this special treatment was that tourism is relatively expensive in Cape Verde and that the industry would be seriously harmed by the 15 per cent VAT rate.¹¹⁸ Since tourism has been selected as the growth engine of the Cape Verdean economy, it was granted these benefits. Added to the rate reduction in the VAT, the companies that undertake what has been defined as tourism are granted full exemption from the corporate income tax during a period of five years, and then another ten years of 50 per cent reduction of the same tax. All imports used for the implementation of their business are exempt from taxes.¹¹⁹ Fiscal benefits granted the tourism sector account for one fifth of total fiscal loss resulting from the fiscal incentives in the tax system.¹²⁰

Like many developing countries, Cape Verde aims at attracting foreign direct investment and uses the tax design as an instrument. The tax system is very generous to foreign investors, offering them five years of full exemption from the corporate income tax. When the five years have passed, they pay the single income tax at a reduced rate. Profits and dividends that are reinvested in the project are exempt from the income tax, with no time limit.¹²¹ Moreover, all imports used for the implementation of their business are exempt from taxes.¹²²

Like foreign direct investment, remittances from Cape Verdean migrants are important to the country's economy. In 2007, remittances accounted for around 20 per cent of GDP. Cape Verdeans that are resident outside of the country are granted exemptions from the Single Property Tax when they purchase land or obtain a license for construction. These exemptions are meant to provide emigrants with incentives to use remittances for investing in Cape Verde.¹²³

¹¹⁸ Moreira: 2009-04-30

¹¹⁹ Varsano et al: 2009: p. 18

¹²⁰ Note: own calculations, source of data: Varsano et al: 2009: p. 8

¹²¹ Varsano et al: 2009: p. 18

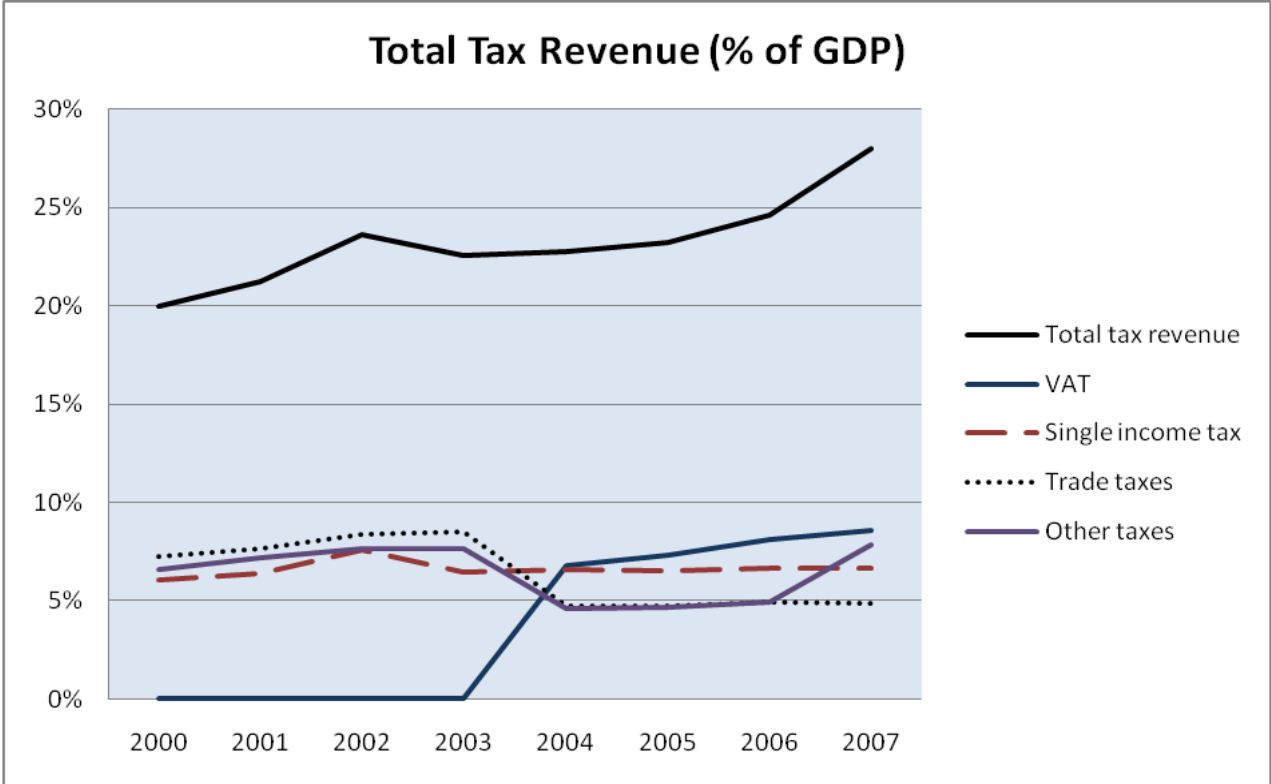
¹²² Moreira: 2009-04-30

¹²³ Moreira: 2009-05-29

4.7. Revenue Effects

As a result of the reforms outlined in this chapter, the volume of tax revenue in Cape Verde has grown steadily over the last ten years, both in absolute terms and in relation to GDP. From 2000 to 2007, total government tax revenue grew from 19.9 per cent to 28 per cent of GDP.¹²⁴

Figure 3. Total government tax revenue as share of GDP, 2000-2007



Note: Own calculations. Source of Data: BCV

As illustrated by figure 3, this increase seems to be mainly due to the introduction of the VAT. Revenue from the VAT has, since its introduction in 2004, grown from 6.8 per cent to 8.6 per cent of GDP, accounting for the largest increase generated by one single tax. Revenue from the Single Income Tax has grown at the same pace as GDP while revenue from taxes on international trade decreased from 7.3 per cent of GDP in

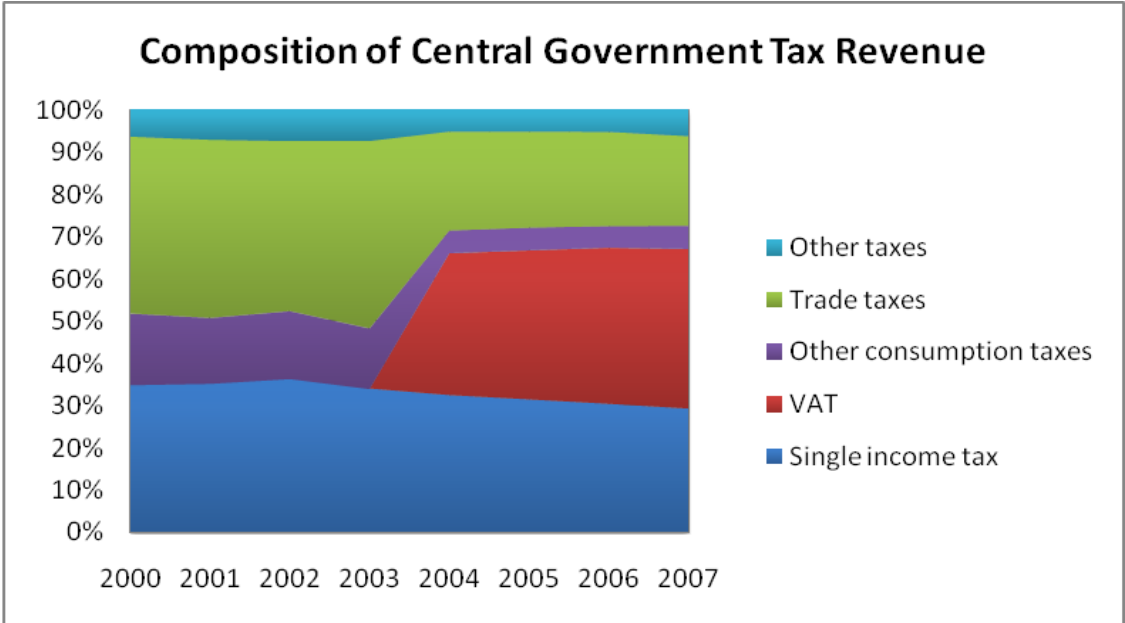
¹²⁴ BCV

2000 to 4.9 per cent in 2007. This is a result of a growing GDP in combination with tariff reductions and the elimination of the customs general fees.¹²⁵

The post “*other taxes*” includes a number of smaller taxes where the Property Tax, the Special Consumption Tax and the Stamp Tax are the most important. These have been grouped together for diagram simplicity and in order to maintain focus on the larger taxes. The total revenue from these smaller taxes has fluctuated some but observing the value in 2007, it has increased somewhat compared to 2000.

A further analysis of the composition of government tax revenue concludes that revenue reliance has shifted between the different taxes. The figure below shows the composition of central government tax revenue.¹²⁶

Figure 4. Composition of total central government tax revenue, 2000-2007



Note: Own calculations. Source of data: BCV

As illustrated by the diagram, total revenue from taxes on international trade has decreased significantly as a share of total tax revenue. The decline is in part due to the elimination of customs general fees and in part due to a decline in tariff revenue as a share of total tax revenue. Although the absolute value of total tariff revenue has

¹²⁵ BCV

¹²⁶ Central government tax revenue does not include the single property tax since this tax is municipal.

shown a slight increase, tariff revenue as a share of total central government revenue declined from 29 percent in 2000 to 20.5 per cent in 2007.¹²⁷

The declining share of trade tax revenue in total government tax revenue has been more than matched by revenue collected from the VAT. As a share of total central government tax revenue, this reached 33.6 per cent in 2004, when the VAT was first introduced, and increased to 37.8 per cent in 2007. The “*other consumption taxes*” displayed in the diagram consist of i) before 2004; the Consumption Tax, the Petroleum Tax and the Tax on Alcohol and Tobacco and ii) after 2004; the Special Consumption Tax. The diagram shows that revenue from these taxes has declined relative to total revenue. Adding them to the VAT, it may clearly be concluded from the diagram that domestic consumption taxes have increased in importance significantly as a result of reforms.

In spite of rate reductions, revenue from the Single Income Tax has grown steadily since 2000, in absolute terms. According to Emanuel Moreira, General Director of the Directorate-General of Tax, this is because the reductions have led to increased economic activity. He believes that the reduction that is suggested in the state budget of 2009 will also be offset in terms of revenue because of increased activity and improved administration.¹²⁸ As shown in figure 4, the growth of total tax revenue has led to a slight decline in revenue from the Single Income Tax as a share of total revenue.

The post “*other taxes*” is mainly constituted by the Stamp Tax but also includes fines and other penalties. It has remained rather unchanged during the examined years.

To sum up, revenue statistics clearly show that reforms have significantly improved the tax system’s ability to collect revenue. Its efficiency has reached a level where GDP elasticity exceeds one and revenue grows faster than GDP. Moreover, the composition of total tax revenue shows that reliance on trade taxes has decreased while that of domestic taxes has increased. The most notable modification in central

¹²⁷ Note: own calculation, source of data: BCV

¹²⁸ Moreira: 2009-05-29

government tax revenue seems to be the revenue from taxes on international trade giving way to revenue from consumption taxes.

5. Evaluating the Cape Verdean Tax Reforms

Building on the results presented in the previous chapter, this chapter analyzes the tax reforms implemented in the Cape Verdean fiscal system. This time, the analysis goes beyond revenue effects and considers the different aspects which were described in the theoretical framework laid out in chapter 2. Some of these aspects are also put in the context of trade liberalization.

5.1. Efficiency

As presented in chapter 2, the efficiency of the tax system is a central aspect in tax policy theory. Due to reforms, the efficiency of the Cape Verdean tax system has been significantly improved. Firstly, drastic changes in the tax design have brought about important efficiency gains. The tax base has been broadened through the introduction of the VAT. This is true because it applies to more goods than both the former Consumption Tax and tariffs and because it is levied on all levels of production, letting less added value escape. Services are also taxed, which implies a broadening of the tax base compared to the pre-reform design.

With the tax base broadened, rates have been lowered. Reforms of the structure of import taxes have lowered the maximum tariff rate as well as the applied rates significantly, and consumption taxes as well as income taxes have had their rates lowered. The lower rates reduce distortions of economic decisions and thereby ease dead weight losses. They also normally reduce fiscal evasion since they weaken incentives to avoid paying taxes. Whether fiscal evasion has decreased in Cape Verde is difficult to determine since there are no reliable estimations of the size of the informal sector. However, the strong growth in government tax revenue speaks in favor of the probability of its reduction. Moreover, the introduction of simplified regimes broadens the tax base and captures taxpayers that would probably operate informally otherwise.

Further, the tax design and tax legislation have been very simplified through the notable reduction in the number of taxes. This improves efficiency by making

administration simpler and reducing tax authorities' costs as well as making it easier for taxpayers to fulfill their tax obligations.

Efficiency gains have not only been achieved through tax design modifications; tax administration has also, as described, undergone immense improvements. Digitalization of data, informatics systems and contracts with financial and other institutions are accomplished improvements and constitute characteristics that are essential to a functioning tax collection. These improvements, however, seem to be the first steps in a long process. The administration's tools of registration and digitalization are modern and capable, but as long as the bookkeeping of companies is not satisfactory or standardized, these tools cannot be used fully. As described, a majority of companies pay their tax dues according to simplified regimes but still the revenue from taxes paid according to normal regimes is larger in total.¹²⁹ Naturally, each taxpayer in the normal regimes contributes larger sums but it is likely that the small companies in simplified regimes could contribute more, had they kept organized accounts of their business. Also, since the VAT is different in the simplified regime and functions more like a sales tax, some of the positive aspects that the regular VAT entails, due to its defined structure, are not being captured there. To fully take advantage of the efficiency of the VAT, the share of taxpayers contributing through the normal regime needs to increase. A census on business in Cape Verde carried out by the National Institute of Statistics shows that only 25 per cent of the total number of active companies in Cape Verde have organized bookkeeping, which is required in the normal regimes of the VAT and the personal income tax.¹³⁰ Therefore, improving corporate managing capacity should be a priority. At the time of writing, a support program is about to be initiated by the Ministry of Economy, Growth and Competitiveness in Cape Verde. The support is in this case directed at small companies and is aimed at strengthening the private sector by offering technical assistance in corporate management. Although it does not entail any specific parts regarding tax payment it does have consequences even for the tax authorities. The reason for this is that by making it possible for companies to benefit from the positive

¹²⁹ Moreira: 2009-05-29

¹³⁰ INE: 2009

aspects of operating in the formal sector, such as increased opportunities of getting access to loans, there is a chance of outweighing the costly aspects, i.e. paying taxes.¹³¹ By making it more attractive for companies to operate in the formal sector, the informal sector will be limited. In many cases, the companies lack knowledge of how to establish the organized bookkeeping that is required, and providing technical support for such companies may very well be a profitable project for the companies as well as for the government. However, since the program has not been initiated yet, its effectiveness can not be evaluated in this paper. Nevertheless, the number of companies with organized bookkeeping seems to be evolving in the right direction. In 2007, it was 2.4 times larger than in 2002.¹³²

For tax administration, moving from trade taxes towards domestic taxes implies a more complicated task, as described in chapter 2. Despite the weaknesses still prevalent in Cape Verdean administration, the growth of tax revenue shows that it is capable of collecting domestic taxes, in particular the VAT, rather effectively. The fact that Cape Verde imports a lot suggests that the difference in administration brought by this transition may be smaller for Cape Verde than for other countries since such a large share of the VAT is collected at the border. Around 61 per cent of VAT revenue is collected by the customs at the border and the customs' administrative system is the same regardless of whether they are collecting tariffs or VAT.¹³³ This is not to say that the customs' tax collection could not be improved – there are still problems such as underdeclaration of value of import goods or prevalent corruption¹³⁴ – but as for the challenges brought about by the reforms, the above may be of relevance.

Although reforms have improved the tax administration of Cape Verde immensely, there are still shortcomings to deal with. Regarding the most important weaknesses of the tax administration of Cape Verde, the lack of personnel and education seems to be central. Educating tax officials is a country-specific matter that needs to be done within the country but Cape Verde still fails to do so in a satisfying manner. According to Moreira, tax administrations in the different municipalities are

¹³¹ Cardoso: 2009-05-27

¹³² INE: 2009

¹³³ Note: own calculations, data: DGA and BCV

¹³⁴ Borges: 2009-05-21

significantly less efficient than in the main tax authorities. There are various projects of technical assistance going on at the moment in order to improve the municipalities' technological capacity, but apparently this is an urgent problem, especially since the municipalities are in charge of collection of some important taxes, mainly the Single Property Tax.¹³⁵

Limiting fiscal evasion is one of the large challenges faced by the administration, calling for further improvement. Moreira even believes that limiting fiscal evasion could be enough to recover the revenue that will be lost in the future as a result of the lowered income tax rate and future tariff reductions.¹³⁶

Another feature described in tax policy literature as potentially efficiency-hindering is fiscal incentives. As mentioned in chapter 2, these should only be used if effective and well-targeted. The Cape Verdean system is full of such incentives and although they have not been deeply looked into in this study, it seems relevant to convey some viewpoints in the discussion. A report carried out by the IMF recommends that the incentives should be limited; the exemptions from the VAT should be reduced and the exemptions and rate reductions in the Single Income Tax should be abolished for all new investments and expansions. The reason is that the control or calculation regarding how the incentives actually benefit the economy is not sufficient, considering the voluminous fiscal losses they cause.¹³⁷ The report estimates the total fiscal loss resulting from tax incentives to approximately 17 per cent of total tax revenue in 2007.¹³⁸ However, the investment agency, Cape Verde Investments, which is responsible for granting incentives to investment projects, does so on the basis of an analysis of the project and its potential external effects, requiring positive external effects for the granting of incentives.¹³⁹

The other main area where incentives are used is the tourism sector, which enjoys a lower VAT rate. According to Moreira, the prices in this sector were not reduced when the tax reduction was granted. The IMF report referred to above states that this rate should, gradually, be raised to 15 per cent due to the fiscal loss that it

¹³⁵ Moreira: 2009-05-29

¹³⁶ Ibid

¹³⁷ Varsano et al: 2009: p. 23-25

¹³⁸ Ibid: p. 26

¹³⁹ Miranda: 2009-05-28

causes.¹⁴⁰ Nevertheless, should the FDI and the tourism sector be sensitive to incentives, reducing them might reduce the level of investment and tourism activity, which could have a negative effect on growth as well as tax revenue.

5.2. Equity

The second key concept brought up in the theory of tax policy for development is equity. With the simplification of the tax structure, the system's ability to treat similar goods equally was improved, which was one of the objectives of the simplification. Replacing tariffs with the VAT has further improved this ability since such a process implies equal treatment of imported and domestically produced goods. Further, the number of exemptions and deductions has been reduced, improving horizontal equity. Expanding the tax system to include services further improves horizontal equity. Finally, as the system becomes more efficient and reduces the informal sector, the fact that the group of people paying taxes is growing improves horizontal equity further.

As well as the horizontal equity, vertical equity has been affected by reforms, although less unambiguously. This matter will be discussed in section 5.4.

5.3. Federalism

Within the large reforms of the Cape Verdean public sector, there has been important decentralization of the public administration. Municipalities have been given higher autonomy in several fields and both their budgets and their expenses have been increased. Their revenue now stems from transfers from the central government on the one hand and collection of the Single Property Tax on the other.¹⁴¹ Since Cape Verde consists of islands, the municipalities differ significantly in size, population, climate, resources etc. Hence, there are definite efficiency gains in moving the decision making closer to the needs. However, the fact that the technological capacity has reached a higher level in the central government administration than in the municipal administrations makes tax collection less efficient in the municipalities.¹⁴² Hence, in

¹⁴⁰ Varsano et al: 2009: p. 11

¹⁴¹ Semedo: 2009-05-18

¹⁴² Ibid

terms of efficiency, the decentralization of the fiscal system brings about both losses and gains. If the technological progress of the municipalities continues to be enforced, the gains may nevertheless grow stronger in the long run.

In the pre-reform system, the central government collected all taxes, including those on international trade. With the introduction of the Single Property Tax, the municipalities gained higher autonomy. This was however rather an objective of the reform than a consequence of the fiscal transition – i.e. government revenue becoming less dependent on trade taxes and more dependent on domestic taxes. Currently, the Single Property Tax still accounts for a relatively small share of total municipal revenue and transfers from the central government are relatively more important for the municipalities.¹⁴³ The VAT and the Single Income Tax are the main sources of total tax revenue, so unless some of the collection of these taxes is relocated to the municipalities or the Single Property Tax is used to recover lost tariff revenue, the fiscal transition brought by trade liberalization will not in itself affect the federal system of Cape Verde.

5.4. Redistribution and Poverty

This section includes an analysis of how reforms have affected the vertical equity of the system. The discussion of this concept is more complex and ambiguous than the one that horizontal equity gives rise to. Firstly, the Single Income Tax has differentiated rates as an attempt to redistribute income. During the past few years, the structure of the tax system has been made less progressive as marginal rates of the income tax have been lowered, reducing the vertical equity of the design. Nonetheless, the reduced vertical equity of the tax design does not necessarily imply that the redistributive capacity of the system has been weakened. Public finance theory suggests that the level of tax revenue and the distribution of benefits are more important determinants of progressiveness than the tax design. Hence, if rate-reducing reforms succeed in encouraging investments that enhance growth and create employment as intended, they may result in increased revenues and if these are spent on transfers to the poor, redistribution may actually increase. As shown earlier,

¹⁴³ Semedo: 2009-05-18

revenue from the income tax has grown steadily since 2000 so although made less progressive in terms of design, the redistributive capacity of this tax may have increased - it depends on how the revenue is spent.

The perhaps most important part of Cape Verdean tax reforms was the introduction of the VAT. As mentioned, this tax is known to be recessive. Cape Verdean policy makers have attempted to limit this characteristic by exempting essential goods and supplementing the VAT with the Special Consumption Tax on luxury goods. However, as discussed in previous sections, exemptions complicate the tax design and are costly in terms of efficiency, and it may therefore be more efficient to redistribute income through transfers that benefit the poor. Under the special circumstances of Cape Verde, however, direct transfers are complicated by the very different needs in different areas that the island structure gives rise to,¹⁴⁴ and the question is if the public sector is efficient enough to successfully carry such a system or if perhaps the exemptions are the most efficient alternative at this time.

Further, the progressivity of the system cannot be determined only by examining the rate structure and level of revenue, since the tax incidence does not always fall on the one it was meant to fall on. Theory tells us that targeted taxes often burden other than those intended. Who carries the incidence of the Cape Verdean Special Consumption Tax – introduced to make the system progressive – cannot be determined here, but it can be said that since its introduction has reduced the number of goods subject to an excise tax, it is likely that reforms have at least reduced the problem of burdening other than those intended.

Moving from theory and consulting the statistics to evaluate the redistribution in the tax system of Cape Verde, one can conclude that the redistributive effect is not confirmed. The study from 2006 predicting the impact of EPAs presents statistics showing that, as absolute poverty has decreased, relative poverty has increased. In other words, distribution of wealth has become more unequal.¹⁴⁵ This may or may not be a result of the tax system becoming less progressive; the only conclusion that can actually be drawn is that the tax system has not been redistributive enough to hinder

¹⁴⁴ Semedo: 2009-05-18

¹⁴⁵ Ferreira et al: 2006: p. 89

the increase in income disparities. However, a few years have already passed since these statistics were compiled and the effect of the more recent reforms may therefore not be analyzed.

Recalling the background of this evaluation – what effect will the transition from trade taxes to domestic taxes have on redistribution? Firstly, should the EPAs result in a significant drop in government revenue, redistribution may be harmed for the reason described above. On the other hand, the domestic taxes contain more redistributive instruments than the trade taxes, so giving them higher importance should enhance the redistributive mechanism. The evolution of the consumer price index of Cape Verde shows that price reductions in many goods considered essential did occur between 2002 and 2005.¹⁴⁶ Reasons for these price reductions may be many but tariff reductions may very well be one of them. Imports have increased since reforms, reflecting both trade liberalization and increased demand as a result of economic growth. As mentioned, statistics also show that absolute poverty has decreased. However, this is thanks to a strong economic growth and a number of factors, so tax reforms cannot be isolated as a cause in this study. What can be said about the tax burden carried by the poor is that there still are import tariffs on many essential goods, although lowered compared to the pre-reform tariff structure.¹⁴⁷ Hence, the exemption of these goods from VAT does not mean that the consumer does not contribute to tax revenue when consuming them. Reducing tariffs would, provided that competition is satisfactory, make them cheaper. Concerning future trade liberalization, information about which import goods will be subject to tariff reductions is required for determination of which consumers will be affected the most.

Although the system's redistributive capacity is difficult to evaluate, it can be said that redistributing income requires a sufficient level of tax revenue. The results of this study show that revenue has increased and is increasing each year, which at least improves the prospects of redistributing income.

¹⁴⁶ INE: 2007

¹⁴⁷ DGA: 2007

5.5. Economic Growth

Closely related to the issues of poverty and redistribution is economic growth. As mentioned, economic growth has been strong in Cape Verde during the past years. Since the determinants of economic growth are many, its rate is not enough to evaluate in what way it is affected by the tax system. Looking closer at how the tax system affects economic activity may however be a way of starting this analysis. In the case of Cape Verde, some important characteristics convey that the high and middle income-earners carry a large part of the burden in the current tax system. The income tax rate is relatively high, especially for high- and middle-income earners, and since an important share of all economic activity is still difficult to control and thereby difficult to tax, revenue depends on companies with organized bookkeeping.¹⁴⁸ Lack of administrative capacity to collect taxes from less organized taxpayers puts heavier pressure on those who already contribute significantly to the tax revenue. Some carry a heavy tax burden while others manage to escape taxes, which harms both horizontal and vertical equity and brings about a risk of discouraging economic activity.¹⁴⁹

In the context of economic activity, it is interesting to examine the tax system's effect on the business climate. "Doing Business" is a publication by the World Bank Group that compares a number of business climate indicators of various countries in the world. In 2007, Cape Verde was ranked 132 out of 178 in the "Ease of Doing Business" ranking.¹⁵⁰ One of the indicators in this ranking is the "Ease of Paying Taxes". This indicator takes into account tax rates, time to comply and number of tax payments per year. In the "Ease of Paying Taxes" ranking for 2010, Cape Verde is ranked number 110 out of 183.¹⁵¹ This is an improvement compared to 2007 when the country was ranked number 117.¹⁵² Although not particularly favorable, this ranking is not presented as a main reason for the poor ranking in the "Ease of Doing Business" in 2007. Nevertheless, compared to the rest of the world, the result regarding the ease of

¹⁴⁸ Mendes: 2009-06-02

¹⁴⁹ Ibid

¹⁵⁰ NOSi: 2007: p. 4

¹⁵¹ PricewaterhouseCoopers/The World Bank Group: 2009: p. 77

¹⁵² NOSi: 2007: p.3- 4

paying taxes is still poor and is caused mainly by a high number of tax payments per year.¹⁵³

In October 2009, the National Statistics Institute of Cape Verde published a census on business in the country, using 2007 as the year of reference.¹⁵⁴ The census shows that the total number of active companies in the country increased by 38 per cent between 2002 and 2007. The share of individual companies, employing five or fewer people, in the total number of active companies declined by 9 per cent in the same time period, while the share of non-individual companies, employing more than five people, increased by the same proportion.¹⁵⁵ Since the Cape Verdean tax reforms have included special conditions for small companies in the tax system, it is of interest to discuss whether these affect the development of companies. Firstly, only individual companies, employing less than five people and with a limited turnover, are allowed to pay the VAT according to the simplified regime. This could provide companies with disincentives to grow. However, such disincentives only arise if the simplified regime is more beneficial to the company than the normal regime. Since the simplified regime does not give the taxpayer right to deduct the VAT paid on inputs from its VAT-dues, its benefits are not certain. Whether or not the simplified regime is beneficial for the taxpayer depends on the size of the taxpayer's turnover related to the added value. This reasoning shows that despite the fact that the share of small companies is large, this analysis cannot draw the conclusion that the special features of the tax design are hindering growth of companies. The large number of small companies may be caused by a number of factors – not to mention the exceptionally small market of the Cape Verde.¹⁵⁶ Also, since the introduction of the VAT, the number of individual companies has declined.

In the analysis of economic growth in Cape Verde, it should be stressed that the economy of Cape Verde functions under rather special conditions. There is a lack of natural resources and rain that strictly limits production. The market for any good is small since the population is only about half a million, which reduces the scope for

¹⁵³ PricewaterhouseCoopers/The World Bank Group: 2009: p. 77

¹⁵⁴ INE: 2009

¹⁵⁵ Ibid

¹⁵⁶ Varsano et al: 2009: p. 40

economies of scale and the building of an efficient production. The island structure complicates production even further because of the defective transport system between the different islands.¹⁵⁷ Hence, services account for a large share of the economy; some 88 per cent of the companies operate in the service sector (accounting for around 80 per cent of total turnover).¹⁵⁸ Import coverage by exports is low. What all this implies for the effects of future trade liberalization is uncertain. On the one hand, since the chance of making Cape Verdean production competitive on the world market is quite small, protecting it might be necessary for its survival. On the other hand, due to the limited production, the tariffs of Cape Verde are likely to be a way of collecting revenue rather than protecting domestic production to a greater extent than in many other countries. This implies that the matter of recovering government revenue loss is the country's central challenge and the problem of harming domestic production is smaller than for other countries. Nevertheless, it may be big enough. Income generation is already limited due to the lack of employment opportunities and the little production that does exist is important for the diversification of the economy. On the other hand, there are aspects of trade liberalization that could enhance production efficiency. One of them is that tariff reductions should lead to lowered import prices, not only of fully produced goods but also inputs. This could reduce costs of production and thereby enhance growth.

¹⁵⁷ Semedo: 2009-05-18

¹⁵⁸ INE: 2009

6. Conclusions and Policy Implications

The aim of this study was to analyze the impact of the fiscal transition that has been taking place in Cape Verde in recent years. The tax reforms have been analyzed with regard to their observable effects on total tax revenue as well as to their observable and possible effects on efficiency, equity, fiscal federalism, growth and poverty. This chapter provides concluding remarks on the results found and provides some policy implications related to these.

The tax reforms that have been implemented in Cape Verde have modified and improved the system significantly:

- Efficiency has been increased through simplified design and legislation, a broadening of the tax base, lowered rates and improvement of administrative capacity.
- Horizontal equity has been improved through simplifications, the reduction of exemptions and deductions and the inclusion of domestically produced goods in the tax system.
- The impact on vertical equity is ambiguous as the design has become less progressive, but the increased level of revenue gives more opportunities for redistribution.
- Poverty has decreased and economic growth has been high during the past years; however, this study cannot isolate tax reforms as a cause.

With relevance to the future trade liberalization in Cape Verde and the challenges it brings to the domestic tax system, the following are the more clear-cut conclusions that this study may draw:

- Trade might lead to increased growth and enhance welfare for consumers through increased consumption opportunities. As the tax system of Cape Verde has proven to be efficient enough to increase revenue at the same pace as GDP grows, it has

the capacity to capture gains from trade, in terms of economic growth, in the state budget.

- Higher reliance on domestic taxes challenges tax administration. Tremendous administrative improvements and a growth in VAT revenue speak for prospects of a successful transition.

Although improved, the tax system of Cape Verde needs further enhancement to achieve growth and poverty reduction, particularly with the challenges brought by future trade liberalization. So how could tax revenue be increased further? Given that the tax burden already is heavy on the high- and middle-income earners who are the ones with the greatest possibilities of investing, increasing rates could be growth-hindering. Rather, recalling the “Ease of Paying Taxes” and the IMF Working Paper on fiscal incentives, the procedures of payment, in particular with reference to the number of payments, should be simplified in order to make tax compliance easier for companies. Further, the fiscal incentives seem to be producing revenue loss in favor of non-determined benefits and should be looked into.

The widespread poverty still makes it impossible for a great number of people to pay taxes. Of those who contribute, the majority do so under simplified regimes, giving way to lost potential revenue and perhaps distorting economic decisions of companies. Since 75 per cent pay the VAT in a way that makes it more similar to a sales tax than a VAT, the positive aspects making the VAT popular in literature are not being fully explored. However, not granting these contributors simplified payment would probably give way to more evasion since the capacity to establish organized bookkeeping is lacking. Hence, another area to focus on in order to improve the efficiency of the tax system is supporting the evolution of the formal private sector and improving organizing skills such as bookkeeping. Yet another area of improvement is the education of tax officials and technological capacity building in the municipal tax authorities.

In short, the most probable ways of increasing revenue, should trade liberalization cause revenue to decline, seem to be through improved administrative efficiency, improved corporate management efficiency and decreased fiscal incentives.

Many countries in the world are facing the same challenge of recovering lost tariff revenue as Cape Verde. Since the Cape Verdean story seems to be successful, it may provide lessons to learn. The administrative improvements and the simplifications that the Cape Verdean reforms have included are some of them. However, since tax policy always needs to take country-specific features into account, it is difficult to say how much can be learned from the case of Cape Verde. This is particularly applicable to Cape Verde due to its somewhat unique features. Administratively, Cape Verde has made much progress and acquired technological knowledge that could surely be used elsewhere. However, reforming public administration in such a manner is costly and requires resources, implying that it may not be feasible for all countries. Moreover, the high import level of Cape Verde makes VAT collection administratively less complicated than it might be for other countries, since such a large part of it is collected by the customs, applying the same system as earlier. Lastly, it is worth noting that the timing of every political reform is crucial to how it is perceived and thereby to its success. One should therefore not forget that the tax reforms in Cape Verde have been carried out in prosperous times, when the tourism has boomed and economic growth has been higher than that of many other low-income countries, possibly affecting attitudes towards taxes.

References

Agell, Jonas; Englund, Peter; Södersten, Jan, *Tax Reform of the Century – The Swedish Experiment*, Uppsala, 1996.

Balassa, Bela, *Tariff Policy and Taxation in Developing Countries*. The World Bank Working Paper, 1989.

Bank of Cape Verde Statistics database, government expenses. *Classificação Económica das Despesas do Governo Central*. Available at www.bcv.cv, Estatísticas, Sector Fiscal, Despesas.

Bank of Cape Verde Statistics database, government revenue. *Receitas to Governo Central*. Available at www.bcv.cv, Estatísticas, Sector Fiscal, Receitas.

Bank of Cape Verde, Statistics database, *Alguns Indicadores da Economia Cabo-verdiana*. Available at www.bcv.cv, Estatísticas, Indicadores.

Baunsgaard, Thomas; Keen, Michael, *Tax Revenue and (or?) Trade Liberalization*. IMF Working Paper, 2005.

Bird, Richard M., *Tax Policy & Economic Development*. Johns Hopkins University Press, Baltimore, 1992.

Bird, Richard M.; Gendron, Pierre-Pascal, *The VAT in Development and Transitional Countries*. Cambridge University Press, New York, 2007.

Bird, Richard M.; Zolt, Eric M., *Technology and Taxation in Developing Countries: From Hand to Mouse*. Mimeo, 2008.

Boletim Oficial - Suplemento Sumário, I Serie Numero 48, Lei nº 34/VII/2008. Assembleia Nacional, Praia, 2008.

Boletim Oficial, *Legislação IVA Publicada no Boletim Oficial*. Direcção Geral das Contribuições e Impostos, Praia, 2005.

Borrmann, Axel; Busse, Matthias; Neuhaus, Silke, *EU/ACP Economic Partnership Agreements: Impact, Options and Prerequisites*. Intereconomics: monthly review of economic trade and development, Hamburg, 2005.

Bureau of African Affairs, *Background Note: Cape Verde*. US Department of State, 2009. Available at <http://www.state.gov/r/pa/ei/bgn/2835.htm>.

Busse, Matthias; Borrmann, Axel; Großmann, Harald, *The Impact of ACP/EU Economic Partnership Agreements on ECOWAS Countries: An Empirical Analysis of the Trade and Budget Effects*. HWWA - Hamburg Institute of International Economics, Hamburg, 2004.

Comissão de reforma da tributação sobre a despesa, *Manual do imposto sobre o valor acrescentado*. Ministério das Finanças, Praia, 2004.

Direcção Geral das Alfândegas, *Pauta Aduaneira* (Structure of Import Taxes), Ministério das Finanças, Praia, 2007.

Direcção Geral das Alfândegas, *Receita por Imposições Aduaneiras - Ano 2003 ao 1º Trimestre 2009*. Ministério das Finanças, Praia, 2009.

Direcção Geral das Contribuições e Impostos, *Síntese do Sistema Tributário*. Mimeo, Ministério das Finanças, Praia, 2007.

Ferreira, António Miranda; Rodrigues, António Costa; Malta, João Campos, *Estudo de Impacto de um Acordo de Parceria Económica*. Sociedade Nacional de Empreendimentos, Portugal, 2006.

Hallaert, Jean-Jacques, *How does a domestic tax reform affect protection against imports? The case of the Republic of Madagascar*. IMF Working Paper. 2008.

Hinkle, Lawrence; Hoppe, Mombert; Newfarmer, Richard, *Beyond Cotonou: Economic Partnership Agreements in Africa*. In *Trade, Doha, and Development - A Window into the Issues* (Chapter 22), edited by Richard Newsfarmer,; The World Bank, Washington D.C., 2006.

IMF – Cape Verde -- Letters of Intent and Technical Memorandum of Understanding, 2007, 2008, 2009.

IMF, *Cape Verde: Seventh Review Under the Policy Support Instrument*, approved by Sharmini Coorey and Aasim Husain. IMF Country Report No. 09/328, Washington D.C., 2009.

Instituto Nacional de Estatística, *Estimativas do PIB na óptica da oferta – preços correntes*. INE, Praia, 2007.

Instituto Nacional de Estatística, *Índice de Preços no Consumidor*. INE, Praia, 2007.

Instituto Nacional de Estatística, *III Recenseamento Empresarial de Cabo Verde – Apresentação dos dados definitivos do III Recenseamento Empresarial*. INE, Praia, 2009.

Keen, Michael, *VAT Attacks!*. IMF Working Paper, 2007.

Mankiw, Gregory N., *Principles of Microeconomics*. The Dryden Press, Fort Worth, 1998.

Ministério das Finanças, *Proposta de lei da tributação sobre a despesa*. Approved by the National Assembly of the Republic of Cape Verde, Praia, 2002.

Moreira, Emanuel, *Linhas gerais de intervenção - Forum promitur. Criação de um ambiente fiscal favorável*. Mimeo, Direcção Geral das Contribuições e Impostos, Praia, 2005.

Núcleo Operacional para a Sociedade de Informação, *Projecto "Casa do Cidadão" – Produtos "Empresa no dia", "Certidões online", "Registo de Propriedade Automóvel"*. Mimeo, NOSi, 2007.

PricewaterhouseCoopers, *Sustainability Impact Assessment of the EU-ACP Economic Partnership Agreements*. PricewaterhouseCoopers, Paris, 2007.

PricewaterhouseCoopers/The World Bank Group, *Paying Taxes 2010 – The global picture*. The World Bank, Washington DC, 2009.

Rajaraman, Indira, *Fiscal Restructuring in the Context of Trade Reform*. National Institute of Public Finance and Policy, Delhi, 2004.

Tanzi, Vito; Zee, Howell, *Tax Policy for Developing Countries*. IMF, Washington D.C., 2001. Preface available at: <http://www.imf.org/external/pubs/ft/issues/issues27/index.htm>

Theodossiadis, Love, 2004. *Tax Reforms and Macroeconomic Stabilization in Mozambique*. Department of Economics, Lund University.

TradeCom Facility, *Cape Verde's Market Access Commitments for Trade in Goods and Services*, Under the Support Cape Verde's Post-Accession to the WTO, Appendix 1. Mimeo, TradeCom Facility, 2008.

Zouhon-Bi, Simplicio G; Nielsen, Lynge, 2007. *ECOWAS – Fiscal Revenue Implications of the Prospective Economic Partnership Agreement with the EU*. Africa Region Working Paper Series Number 103. The World Bank.

Varsano, Ricardo; Villela, Renato, *Cabo Verde – Racionalização dos Benefícios Fiscais*. Mimeo, IMF, Department of Public Finance, 2009.

WTO, Statistics database, trade profiles, *Cape Verde*. <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=CV>

Consulted People in Praia (April-June 2009)

Borges, Olivio; Member of operational group, Direcção Geral das Alfândegas, Ministério das Finanças, data providing and personal interview 2009-05-21.

Campos, Guntar; Member of staff, department of statistics, Direcção Geral das Alfândegas, Ministério das Finanças, data providing.

Fermino, Fernano; Director of Administration and Finance, Instituto Nacional de Estatística, data providing.

Fernandes, Elvio; Member of WTO Group, Ministério dos Negócios Extranjeros, data providing and personal interview 2009-04-29.

Figueiredo, Carlos Guido; Member of staff, Direcção Geral de Estudos e Relações Internacionais, Direcção Geral das Alfândegas, Ministério das Finanças, personal interview 2009-05-20.

Gomes Cardoso, Florentino; Agencia para o Desenvolvimento Empresarial e Inovação, Ministério da Economia, Crescimento e Competitividade, data providing and personal interview 2009-05-27.

Lopes, Arnaldo; Minister's Adviser, Ministério dos Negócios Extranjeros, data providing, assistance and personal interview 2009-04-29.

Mendes, Elisabete; Member of staff, department for Good Governance, UNDP, data providing and personal interview 2009-06-02.

Miranda, Karine Helena; Member of staff, department for Investor Support, Cape Verde Investments, personal interview 2009-05-28.

Monroy, Marina; Customs Controller, Direcção Geral das Alfândegas, Ministério das Finanças, data providing and assistance.

Moreira, Emanuel; Director, Direcção Geral das Contribuições e Impostos, Ministério das Finanças, data providing and personal interviews 2009-04-30 and 2009-05-29.

Semedo, Claudino; Director, Direcção Geral do Orçamento, Ministério das Finanças, data providing and personal interview 2009-05-18.

Spencer, Carlos; Customs Controller, Direcção Geral das Alfândegas, Ministério das Finanças, data providing and assistance.

Vieira, Adalberto; Director Geral, Inspeção Geral das Actividades Económicas, Ministério de Economia, Crescimento e Competitividade, personal interview 2009-05-27.

MINOR FIELD STUDY SERIES (A complete list can be ordered from Department of Economics, University of Lund, Box 7082, S-220 07 Lund, Sweden)

- 179 Åsa Hindenborg On the Role of Remittances in Microfinance – Creating Transnational Financial Services in El Salvador. 2007:6
- 180 Linna Palmqvist Corporate Social Responsibility and Development – A case study of the CSR strategies of international companies in India. 2007:7
- 181 Peter Holmvall Remittances and Poverty – A case study of the Philippines. 2007:8
- 182 Charlotta Undén Multinational Corporations and Spillovers in Vietnam – Adding Corporate Social Responsibility. 2007:9
- 183 Emil Samnegård How Does Fairtrade Affect the Market? A Case Study in South Africa. 2007:10
- 184 Emma Svensson Microfinance, Financial Systems and Economic Growth – A Theoretical Framework and Findings from Bolivia. 2007:11
- 185 Sonja Luoma
 Maria Persson A Path to a Life of Dreams? A Study on Financial Markets, Microcredit and Gender in Uganda. 2008:1
- 186 Gabriel Andréasson Evaluating the Effects of Economic Sanctions against Burma. 2008:2
- 187 Katarina Öjteg Socio-economic Determinants of HIV in Zambia – A District-level Analysis. 2009:1
- 188 Tora Bäckman Fairtrade Coffee and Development – A Field Study in Ethiopia. 2009:2
- 189 Sara Forssell Rice Price Policy in Thailand – Policy Making and Recent Developments. 2009:3

- 190 Tora Hammar Trade Facilitation in Vietnam – Recent Progress and Impact. 2009:4
- 191 Joakim Persson The Impact of a Quota System on Women’s Empowerment – A Field Study in West Bengal, India. 2009:5
- 192 Erudita Hoti Remittances and Poverty in Albania. 2009:6
- 193 Anna Andersson Made in Madagascar – The Impact of Rules of Origin on the Textile and Clothing Industry. 2009:7
- 194 Sigrid Colnerud Granström The Informal Sector and Formal Competitiveness in Senegal. 2009:8
- 195 Elin Jönsson Elin Åkerman Direct Cash Transfer and Food Security in Georgia. 2009:9
- 196 Ylva Kalin FDI in Colombia – Policy and Economic Effects. 2009:10
- 197 Lisa Curman Ownership of the Poverty Reduction Strategy in Rwanda. 2009:11
- 198 Helena Lundstedt Sara Pärssinen Cocoa is Ghana, Ghana is Cocoa – Evaluating Reforms of the Ghanaian Cocoa Sector. 2009:12
- 199 Johan Fredborn Larsson The Transition in Kazakhstan – From Command to Market Economy. 2010:1
- 200 Gustaf Salomonsson Oscar Sandberg Assessing and Remediating the Natural Resource Curse in Equatorial Guinea. 2010:2
- 201 Hanna Nilsson Structure, Reforms and Performance of the Ugandan Cotton Sector. 2010:3
- 202 Annika Marking Trade Liberalization and Tax Reforms in Cape Verde. 2010:4