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DJIBOUTI

SELECTED ISSUES

March 18, 2024

Approved By
Middle East and Central Asia Department

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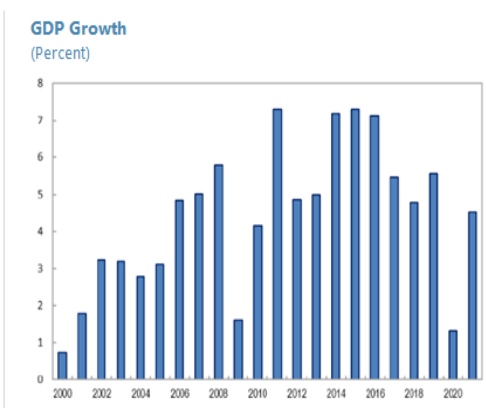
EMPOWERING DIVERSE FUTURES: LABOR MARKET DYNAMICS AND INCLUSIVE GROWTH IN DJIBOUTI[1]

The economy of Djibouti grew at an unprecedented rate during the last decade, but the investment-led economic expansion did not translate into tangible labor market's improvements. The capital-intensive nature of the country's growth model limits job creation, while growing skill mismatches in the labor market have increased structural unemployment. While access to education has increased dramatically since the 2000s, more could be done in improving the quality of education and expanding vocational and adult learning. Moreover, stepping-up diversification would support the development of more labor-intensive sectors, further spreading the benefits from growth to all Djiboutians.

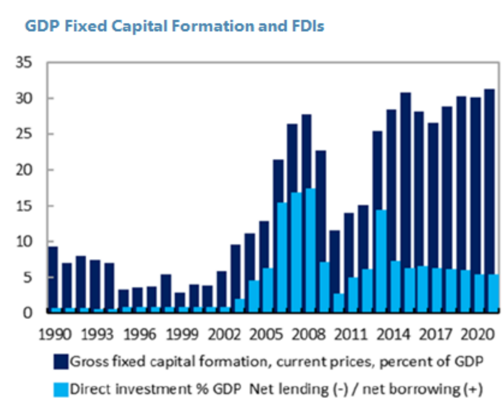
A. Introduction

1. **Djibouti economic boom has been sustained by large infrastructure investments.** After modest growth in the two decades following independence, the economy of Djibouti expanded strongly from the beginning of the 2000s on the back of political stability and a surge in foreign-financed investment aimed at developing the country's ports and railways infrastructure (Figure 1). Economic growth accelerated from the mid-2000s after the completion of the first investment projects, with the level of real GDP growing by 50 percent between 2013 and 2021.

Figure 1. Djibouti: Economic Boom Has Been Supported by Significant Infrastructure Investments



Sources: Djibouti Authorities; and IMF staff calculations.



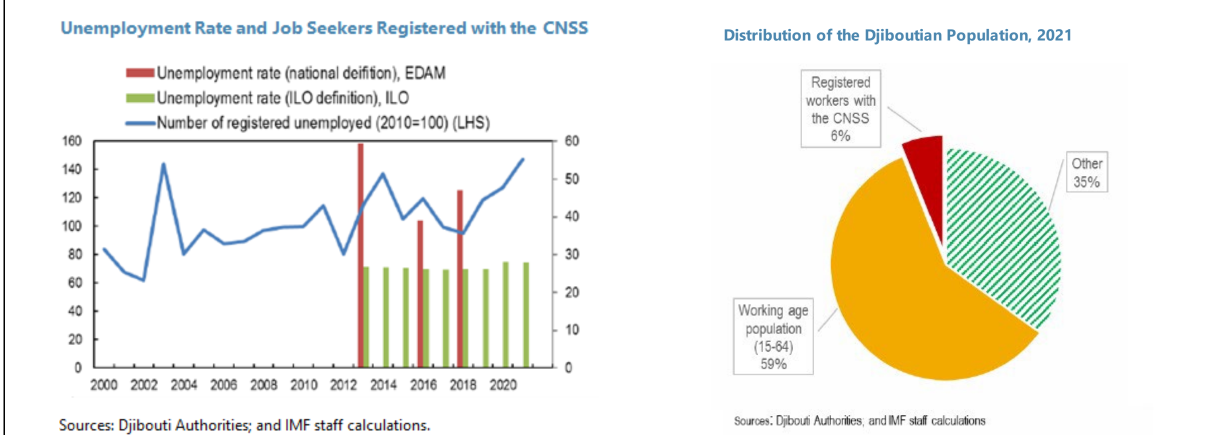
Sources: Djibouti Authorities; and IMF staff calculations.

2. **Despite strong growth, labor market improvements remain elusive, weighting on social conditions.** Available data suggest that the strong economic expansion of the last two decades did not deliver significant formal labor market gains. Despite an average growth rate of

[1] Prepared by Filippo Gori and Rhea Gupta.

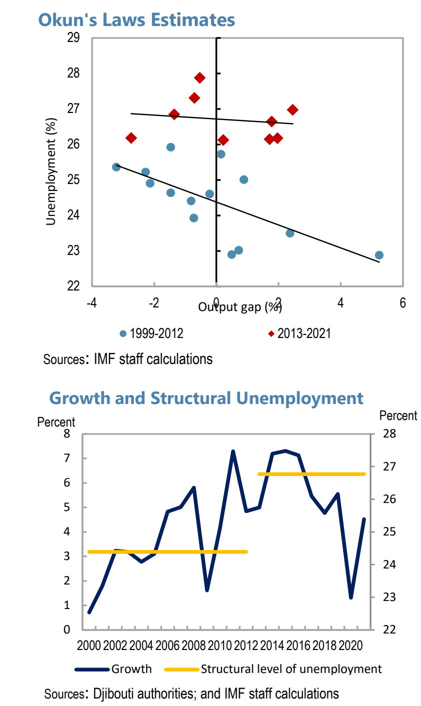
5.5 percent since 2005, in 2017 the unemployment rate using national definitions, was as high as 47 percent—higher than its 1996 level of 44 percent. Labor force participation was only 45 percent (32 percent among women) and labor informality reached 50 percent, exposing one worker in two to precariousness, low earnings, and poor working conditions in general (EDAM, 2017). As of 2021, the number of Djiboutians participating in formal employment remain strikingly low, with the *Caisse Nationale de Sécurité Sociale* reporting only around 67,600 registered workers, corresponding to only about 10 percent of the working age population (Figure 2). Poor labor market outcomes have hampered social improvements. In 2017, extreme poverty rate reached 21 percent, with rural regions showing rates more than twice as high (45 percent) (EDAM, 2017).

Figure 2. Djibouti: Growth Has Not Translated Into Corresponding Labor Markets Gains



3. An examination of Okun's Law provides valuable insights into the primary labor market challenges facing the economy of Djibouti. This study delineates critical features of Djibouti's labor market, elucidating the factors underlying the discrepancy between robust GDP growth and inadequate job creation. The analysis employs Okun's Law as a methodological framework, allowing for the accommodation of potential fluctuations in its coefficients amid the period of heightened investment activity. Findings suggest a notable structural shift in labor market dynamics which coincided with the surge in investment, generating two important effects: the economy's increasing dependence on capital-intensive sectors lowered the job intensity of growth (i.e. slower job growth relative to overall economic growth) while higher capital and technology levels widened the skill mismatch between labor supply and demand, ultimately generating a higher structural level of unemployment.

Figure 3. Djibouti: The Okun's Law Has Changed

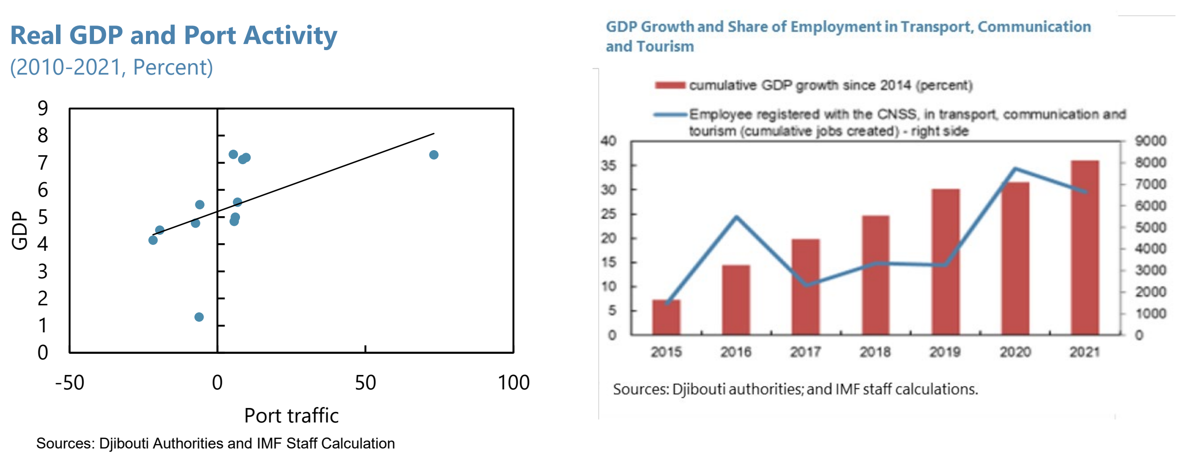


B. Okun's Law Estimates for Djibouti

4. A structural break emerged in the labor market as the country benefited from a surge in investment. The estimated equation and results are reported in the annex. Results suggest that job creation became less sensitive to economic growth during the investment boom in 1999–2012. During this period, the estimated impact of a 1 percent output gap on unemployment declined from 0.32 percent to 0.05 percent. Moreover, the natural level of unemployment (ILO definition) also changed during the same period, increasing by about 2.4 percent, from 24.4 percent to 26.8 percent. These results suggest that, during the Djibouti's investment boom, the slope of the Okun's has declined and the relationship has shifted up (Figure 3). These effects are discussed in detail below.

5. The pace of job creation slowed during the investment boom. During the last decade, the pace of job creation conditional on output has declined. Okun's law coefficients suggest that during the period 1999-2012 a 3 percent output gap was associated with a 1 percent decline in unemployment, while since 2013 the impact appears six times smaller. Determinants of the slope of the Okun's law can be multiple, including job informality (Bizimana and Arzoumanian 2022), labor-technology complementarities, and sectoral composition. While informality may be high in Djibouti,[2] this appears to be a historical fact and not a recent phenomenon. Thus, a sizable decline in the job intensity of growth which coincides with infrastructure investments appears more consistent with structural changes to the economy favoring capital-intensive projects and generally job-scarce service activities such as those related to transit trade. During the period 2010-2021 about 80 percent of the variation in GDP growth is explained by growth in port activity. However, modern ports facilities do

Figure 4. Djibouti: Reliance on Capital Intensive Sectors for Growth Has Curbed Employment Generation

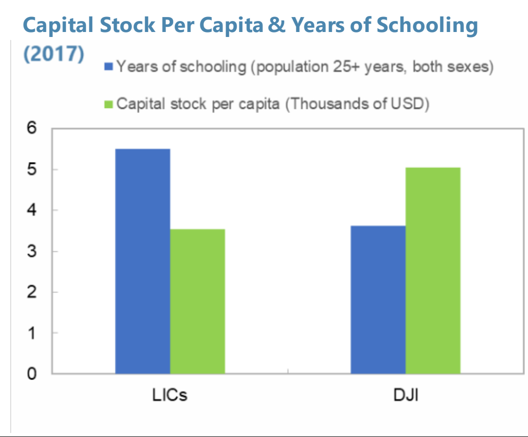


[2] There are no official statistics concerning informality in Djibouti. ILO Estimates suggest that in 2017 there were 41795 informal workers out of a total of 82735 workers (EDAM, 2017). These estimates are likely to be biased upward given that, during the same year, there were 61419 registered with the national social security system (CNSS). Despite informality can explain low employment intensity of growth, a structural break in the elasticity of unemployment to growth (the slope of the Okun's law) coincident with the development of the port infrastructure for Djibouti, is more likely to be due to shift toward more capital-intensive activities, as Djibouti port does not employ informal workers.

not generate large employment due to large use of automation. As a result, during the period 2015-2021, the transport sector generated less than 7 thousand new jobs, with respect to a cumulated real GDP growth of more than 35 percent. Comparing this figure with the number of working age population, the economic boom of the last decade directly benefitted only about 1 percent of Djiboutians of working age (Figure 4).

6. Mismatches in the labor market continue to weight on unemployment. Okun's law estimates also suggest that, since 2013, the relationship between output gap and unemployment has shifted-up, resulting in an increase in the structural level of unemployment, from around 24 percent in the period 1999-2012, to almost 27 percent between 2013 and 2021.[3] Higher structural level of unemployment since 2013 signals a growing skill-mismatch between labor demand and supply, which reflects the drastic structural economic change that the economy has faced over the past two decades. The surge of infrastructure investment caused an increase in capital stock that was not matched by a corresponding increase in the workforce's human capital, worsening capital-skill complementarity, calling for substantial education investment and reforms to improve the employability of the labor force with respect to changing employers' needs (Section C). In 2017, Djibouti's capital stock per capita reached $5.5 thousands per capita, about 60 percent higher than the average for low-income countries (LICs), while 62 percent of the labor force had no schooling (against about 30 percent on average for other LICs) (Figure 5).[4] In the same year, education attainment was a key determinant of labor outcomes, with unemployment among individuals with advanced education less than half the one of those with basic education (EDAM, 2017).

Figure 5. Djibouti: There Are Clear Mismatches Between Human and Physical Capital



C. Potential Policies

7. The country's education system has improved significantly in recent years. In the early 2000s, reforms began in the education system with the aim of expanding access and improving the quality of schooling. More measures followed, aimed at achieving full enrollment, gender parity, and the development of preschool education. As a result, significant progress has been achieved: the gross primary enrollment ratio increased from 51.5 percent in 2004 to close to 100 percent in 2022.

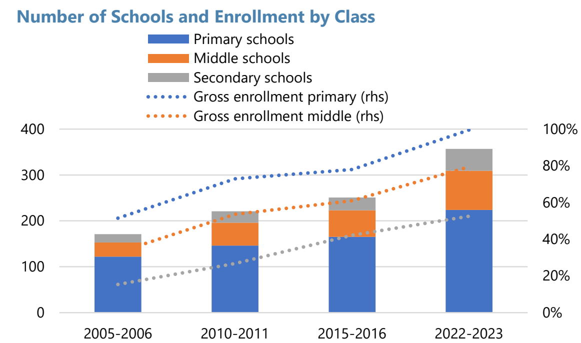
[3] ILO unemployment definition. See the Appendix for more details on the difference between ILO and national unemployment definitions.

[4] Including labor or household surveys from 2000 to 2022 for Afghanistan, Burundi, Benin, Burkina Faso, Bangladesh, Bhutan, Côte d'Ivoire, Cameroon, Congo, Republic of the Democratic, Comoros, Ethiopia, Ghana, Guinea, Guinea-Bissau, Haiti, Kenya, Kyrgyz Republic, Cambodia, Kiribati, Lao P.D.R., Liberia, Lesotho, Moldova, Madagascar, Mali, Myanmar, Mozambique, Mauritania, Malawi, Niger, Nigeria, Nepal (source ILOSTAT).

To accommodate the higher number of students the total number of primary schools almost doubled from 122 in 2005 to 224 in 2022 (Figure 6). Gender disparities have drastically reduced too with 47percent of female students in primary education in 2022, compared to only around 32 percent in 2008.

8. Nonetheless, there is room for improvement. Especially in rural areas, access to preschool is low, and school dropouts in the transition to lower secondary education remains high. As a result, gross enrollment in secondary schools remains at around 50 percent. Quality of education could be improved too, as the primary and lower secondary's pupil teacher ratio (PTR)—a proxy for learning quality and resource availability—remains below the average for lower middle income countries, while the average students per class is high.[5] Moreover, vocational training programs remain underdeveloped, especially in light of the country's tourism development plan, and private higher education sector investment lags behind, despite their potential to lighten the pressure on public schools and, in some cases, actively address the demands of the labor market. Finally, formal education could be paired with adult learning programs (ALP) to increase the skillset of those already in the labor force, as almost 90 percent of individuals found to have no formal education in the 2017 household and labor force survey (EDAM, 2017), are expected to remain in the labor force at least until 2027. Evidence from the implementation of ALP in other developing countries suggest that ALP promote employability and skills development (UNESCO, 2022), participants in such programs implemented in developing countries have shown a greater propensity to transition from economic inactivity or unpaid family work to self-employment, particularly in rural areas (Bluch, 2017).

Figure 6. Djibouti: The Education System Has Improved During the Last Decade



Sources: Direction générale de l'Éducation - Annuaires Statistique

9. A new growth model favoring diversification could reduce dependence on port activities and foster job creation. Promoting alternative economic activities and industries to those related to transit trade and outside free trade zones (FTZs) could improve job creation and diversification. In this regard, a sector that could offer substantial employment opportunities for the country in the near term is construction (*Bâtiment et Travaux Publics*), which authorities project a growth of near 40 percent by 2027. To support domestic employment creation in this sector, training programs would support adequate skilling of the labor force and reduce reliance on foreign workers. Other activities identified by the authorities within the framework of Vision Djibouti 2035 include tourism, the primary sector (fisheries, agriculture, livestock breeding), and mining. With

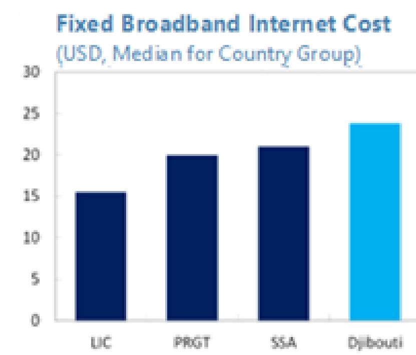
[5] The PTR was 33 and 25 for primary and lower secondary school respectively in 2022-2023, against an average for Lower Middle-Income countries in 2018 of 27 and 20 respectively (UNESCO Institute for Statistics). The number of students per class (Divisions Pédagogique) is between 45 to 50 on average, across primary and secondary education.

revenues representing only 1.9 percent of GDP in 2019,[6] the development of tourism could foster job creation together the development of the primary sector, which can offer important job opportunities, especially for lower skilled workers. Harsh climatic conditions and poor soil quality limit agriculture output, but fisheries and livestock breeding offer growth potential and may support the country's efforts to reduce international food dependency.

10. The development of alternative sectors to the port is expected to require significant investments. The development of the primary sector requires significant improvements in production facilities and in the distribution network. Similarly, while the attraction of Djibouti as a tourist destination has increased in recent years[7] connectivity by air is weak and hotel capacity remains limited both requiring significant investment scale-up.[8] Moreover, access to the main tourist sites remains lacking due to the absence of a reliable domestic transport network. In this regard, investments in enabling sectors can play an important role in the country's diversification plans.

11. Reforming enabling sectors, such as IT and energy which remain state monopolies, could create higher connectivity, better quality, and lower service prices. Energy prices in Djibouti remain high with respect to peer countries, with electricity bills accounting for approximately 25 percent of business expenses (World Bank, 2014), hindering national competitiveness and industrial development (Figure 7). An increase in energy generation capacity could deliver both in terms of higher energy self-sufficiency and reduced carbon footprint, if the new generation capacity is renewable. Despite the nearby presence of several international submarine communication cables, the development, accessibility, and price of telecommunication services in the country is low, which limits the development of the IT industry. In 2017 the country ranked 158 out of 175 in the International Telecommunication Union (ITU) ICT Development Index. Opening these sectors could particularly benefit the non-food manufacturing sector which remains in its infancy representing only the 1.6 percent of the country value added in 2021.

Figure 7. Djibouti: High Telecom Costs Hold Back Growth



Source: ITU and IMF Staff Calculations.

12. A larger role for the private sector would help enable investments for diversification. The authorities have relied on free trade zones and broad tax advantages as drivers for their diversification plans. However, since tax incentives generally rank low in investment climate surveys in low-income countries (IMF, 2015), these are unlikely to compensate for the lack of infrastructure beyond that related to the port and FTZs. The success of Djibouti's diversification thus will require

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[6] International Organization of Tourism.

[7] In 2021 Djibouti received approximately 114,000 tourists, compared to around 63,000 in 2013.

[8] A new airport, expected to handle 1.5m passengers upon completion, is planned in Bicidley, around 60 km from Ambouli.

significant investment for the development and upgrade of hospitality, road and air transport, food processing, IT, and energy infrastructures. Against the background of limited fiscal space, such investment is unlikely to come from public sources, calling for a larger role for the private sector. To this end, liberalization in key sectors, such as IT and utilities, would allow for increased competition and infrastructure investment, possibly in conjunction with international partnerships. Targeted SOEs reforms aimed at improving efficiency can also support private business development, while tax reforms enhancing revenue mobilization (see Selected Issues Paper) may enable public investment.

13. The timely collection of labor market statistics remains a key constraint for supporting decision making and job creation. The design and implementation of adequate policy frameworks to foster job creation requires complete and timely labor market data. The frequent collection of basic labor market data, such the unemployment rate, remains a priority for policy design and implementation. To this end, the capacity of the Djibouti national statical office to carry out regular labor market surveys should be strengthened, even within the framework targeted technical assistance programs by the IMF or other international partners.

Annex I. Estimates for the Okun's Law in Djibouti

1. **Estimating the Okun's law helps shed some light on Djibouti's main labor market weaknesses**. Okun's Law, initially documented by Okun (1962) for the United States, is an empirically observed relationship describing a reverse correlation between cyclical variations in output and the unemployment rate. Economic shocks induce fluctuations in output around its potential, prompting firms to hire or dismiss workers, thereby altering the unemployment rate in the opposite direction. The gap version of the relationship takes the form:

$$\widetilde{u_t} = \beta \widetilde{y}_t + \varepsilon_t \qquad (1)$$

Where $\widetilde{u_t} = u_t - u_t^*$ and $\widetilde{y}_t = \frac{(y_t - y_t^*)}{y_t^*}$ are respectively the unemployment and output gap at time t, such that u_t^* represents the structural level of unemployment and y_t^* the output potential. ε_t is a zero mean idiosyncratic term capturing other shifts in cyclical unemployment. The coefficient β measures the change in cyclical unemployment associated with a 1% increase in the output gap. Equation (1) can be written as

$$u_t = u_t^* + \beta\, \widetilde{y}_t + \varepsilon_t \qquad (2)$$

2. **A complete time series for the unemployment rate is not available for Djibouti, as past unemployment surveys were conducted in conjunction with household surveys, at low frequencies.** Annual frequency model estimates based on historical time series data of the unemployment rate (using the international definition), however, are available from the International Labor Organization (ILO). This series is available for a decade, from 2013 to 2023. A simple regression extension technique is used to extend the time of this time series up to 1999 to increase the number of observations. To do this, information about working age population growth (United Nation's estimates) and the number of job seekers from Djibouti's social security administration (*Caisse Nationale de Sécurité Sociale*) are used. The regression extension model takes the following form:

$$u_t = \alpha + \delta\, \mu_t + \gamma\, n_t + \omega_t \qquad (3)$$

Where μ_t is the log of registered job seekers with the social security administration and n_t is the log of the working age population (15-64). The model is estimated over the time period 2013 to 2022. Regression estimates for Model (3) are shown in Table 1. Despite the very low number of observations which results in limited accuracy, the model appears to fit reasonably well the ILO unemployment rate series, with a share of model-explained variance of around 65 percent. Backward forecasts from Model (3) are used to construct estimates for the unemployment series for the period 1999-2012, that are then used for estimating Model (2). The use of an estimated regressand in Equation (2) is expected to increase the model variance but not to generate estimation bias. Output potential needed for output gap estimates in Equation (2) is inferred using the Hodrick-Prescott (HP) filter.

3. The estimates are shown in table 2. The first column shows estimates assuming time invariant structural level of unemployment. By introducing a dummy variable, in column 2 and 3, the structural level of unemployment is allowed to vary across 2 defined periods, 1999–2012 and 2013–2021. These two periods roughly represent two distinct phases of growth for country, with the latter characterized by the investment boom. In the third column of Table 2, the model is augmented with an interaction term between the dummy identifying the investment boom period (post 2012) and the coefficient measuring the impact of growth on cyclical unemployment.

Table 1. Djibouti: Unemployment Estimates

	(1)
	Unemployment
Registered unemployed	3.208**
	(1.309)
Working age population	4.939^{+}
	(2.940)
Constant	-66.199
	(38.495)
Observations	9
R2	0.650

Note: The unemployment rate refers to the ILO definition. Standard errors in parentheses; + p < 0.14 * p < 0.10, ** p < 0.05,

Table 2. Djibouti: Okun's Law Coefficients 1999–2012 and 2013–2021

	(1)	(2)	(3)
	Unemployment	Unemployment	Unemployment
Output gap	-0.169^{+}	-0.243**	-0.323**
	(0.144)	(0.0659)	(0.0472)
Post 2012		2.386**	2.341**
		(0.334)	(0.317)
Output gap X post 2012			0.270**
			(0.126)
Constant	25.32**	24.39**	24.37**
	(0.296)	(0.219)	(0.220)
Observations	23	23	23
Adjusted R2	0.01	0.71	0.728

Note: The unemployment rate refers to the ILO definition. Robust Standard errors in parentheses; $^{+}$ p < 0.14, * p < 0.10, ** p < 0.05,

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CREATING FISCAL SPACE TO BUILD INCLUSIVE AND RESILIENT GROWTH[1]

A. Introduction

1. **Djibouti's growth model, built around port activity, has brought high growth rates but also shown some fragilities.** Djibouti is a small economy which has leveraged its location in the Horn of Africa to position itself as a port of entry for neighboring landlocked Ethiopia. This has enabled the Djiboutian economy to record growth rates averaging six percent annually between 2013 and 2019. However, this growth model has also shown some fragilities. First of all, capital-intensive growth around port activity has not created enough jobs for the local population. The last unemployment survey, conducted in 2017, estimated an ILO unemployment rate at 27.5 percent, rising to 65.1 percent for 15–34 year olds and 86.2 percent for 15–24 year olds. Secondly, the Djiboutian economy is considerably exposed to shocks on trade, as shown during the pandemic. Thirdly, insofar as Djibouti's ports mainly serve Ethiopia (with Ethiopian trade accounting for about 95 percent of operations), the economic outlook in Djibouti is largely driven by the economic outlook in Ethiopia. This was particularly apparent during the conflict in Tigray between November 2020 and November 2022.

2. **Building a more inclusive and resilient growth model would require human capital which is currently lacking in the country.** Investments in health and education have lagged peers. Djibouti has been falling behind in terms of human development and has made only limited progress towards the achievement of the Sustainable Development Goals. Closing the gap would require a substantial increase in health and education spending.

3. **However, fiscal space has been declining over the last decade.** The revenue to GDP ratio has decreased substantially. At the same time, poor governance of state-owned enterprises (SOEs) has not enabled the state to mobilize dividends from profitable SOEs, while exposing the central government budget to fiscal risks. Losses in revenue may also result from the extent of the informal economy.

4. **Increasing fiscal space will therefore be decisive to build more inclusive and resilient growth.** A concerted and sustained effort to mobilize domestic revenue would be key to invest in health and education and build the human capital which could allow Djibouti to evolve towards a more inclusive and resilient growth model, creating more jobs for the local population, while lowering the country's exposure to shocks.

5. **Reforms in the following four areas will be discussed:** (i) improving SOE governance to mobilize dividends from profitable SOEs and reduce the need for subsidies of others, (ii) facilitating

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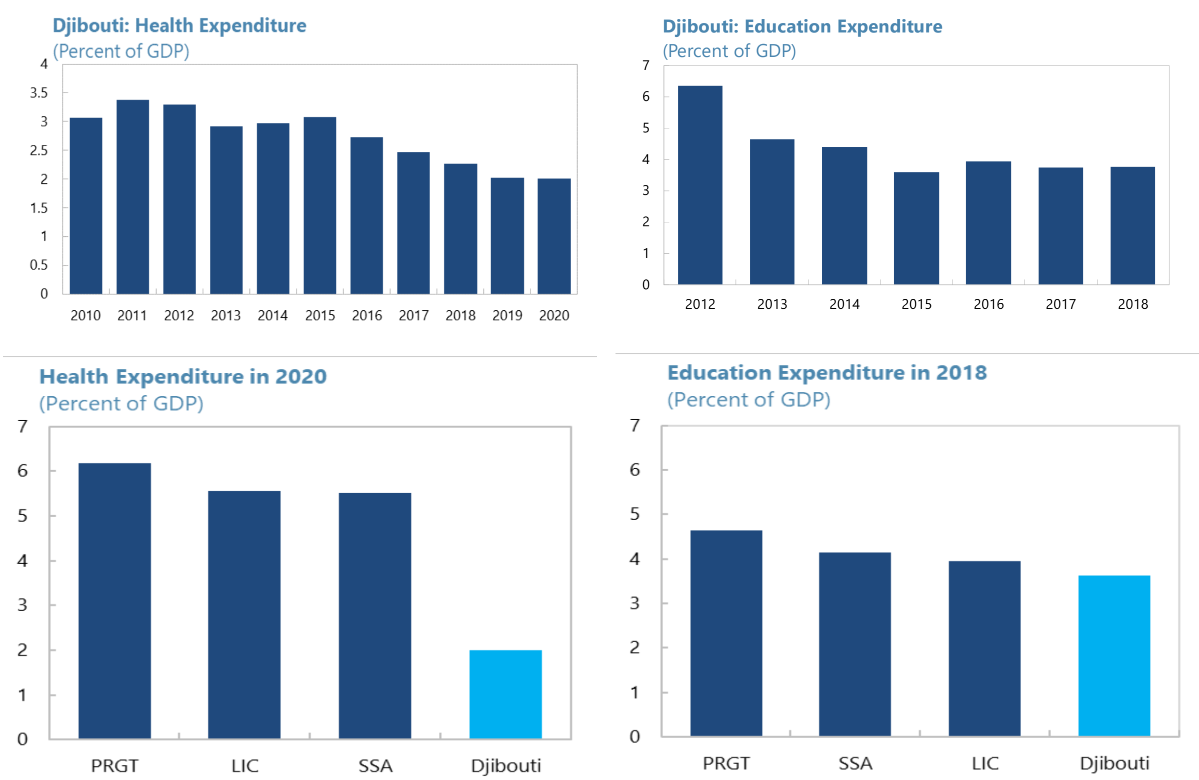
[1] Prepared by Vincent de Paul Kocou Koukpaizan, Sebastien Leduc, and Naima Smaini

formalization to broaden the tax base, (iii) undertaking a deep tax reform anchored on medium-term goals, and (iv) strengthening the tax and customs administrations.

B. Building Human Capital Would Require a Significant Increase in Health and Education Spending

6. Spending on health and education has been declining as a share of GDP and is currently below peers. At around 3 percent from 2010 to 2015, the health expenditure to GDP ratio decreased progressively and stood at 2 percent in 2019 and 2020. Likewise, the education expenditure to GDP ratio decreased from 6.4 percent in 2012 to 3.8 percent in 2018, compared with average rates between 4 and 4.5 percent in Low Income Countries (LICs), Sub-Saharan Africa (SSA) countries or countries eligible to the Poverty Reduction and Growth Trust (PRGT countries). The gap is much higher for health expenditure to GDP with about 5.5 percent on average in LICs and SSA countries and around 6 percent in PRGT countries, against 2 percent in Djibouti (Figure 1).

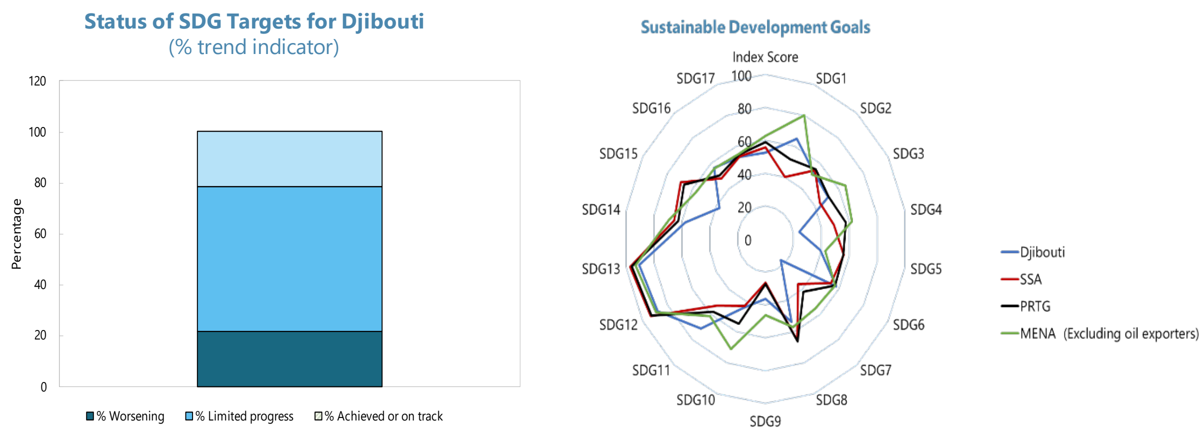
Figure 1. Djibouti: Health and Education Expenditure



Sources: World Development Indicators; and IMF staff calculations.

7. As of 2023, Djibouti had recorded only limited progress in achieving the Sustainable Development Goals (SDGs). The country ranked 150 out of 166. Only 21 percent of the SDGs had been achieved or were on track to be achieved, while 58 percent had recorded only limited progress and indicators had worsened for 21 percent (Figure 2).

Figure 2. Djibouti: Progress in the Achievement of the Sustainable Development Goals as of 2023



Source: Scores range from 0 to 100.
SDG1, No Poverty; SDG2, Zero Hunger; SDG3, Good Health and Well-Being; SDG4, Quality Education; SDG5, Gender Equality; SDG6, Clean Water and Sanitation; SDG7, Clean and Affordable Energy; SDG8, Decent Work and Economic Growth; SDG9, Industry, Innovation, and Infrastructure; SDG10, Reduced Inequalities; SDG11, Sustainable Cities and Communities; SDG12, Sustainable Consumption; SDG13, Climate Action; SDG14, Life below Water; SDG15, Life on Land; SDG16, Peace Justice and Strong Institutions; SDG17, Life on Land.
Sources: Sustainable Development Report (https://dashboards.sdgindex.org); and IMF staff estimates.

C. However, Fiscal Space Has Shrunk Over the Last Decade

Tax Landscape

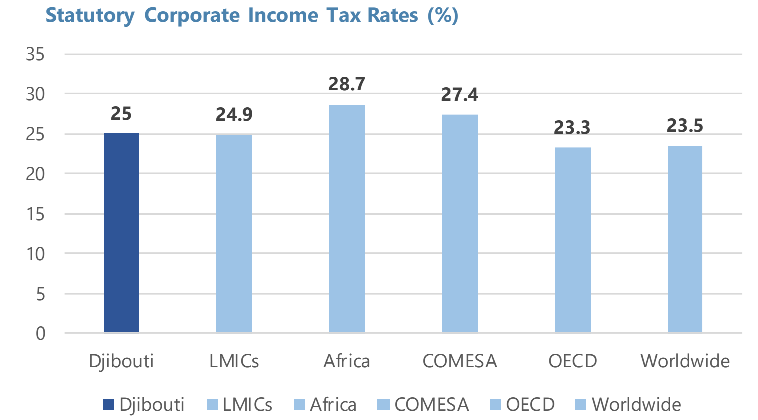
8. Djibouti's income tax regime focuses on taxing wages and business profits. Monthly wages in excess of DJF 50,000 (USD 281) are taxed progressively, with the top marginal rate of 40 percent applying to incomes of DJF 2 million (USD 11,238) or more (Table 1). Business profits of both natural and legal persons are taxed at a flat 25 percent tax rate, which is lower than the average corporate income tax rate in Africa (28.7 percent) but comparable to the average rate for other Lower Middle-Income Countries (LMICs - 24.9 percent) (Figure 3). Unlike most other countries, Djibouti does not tax rental income and most property income (such as dividends and interest). Pensions are also tax exempt.

Table 1. Djibouti: Personal Income Tax Brackets

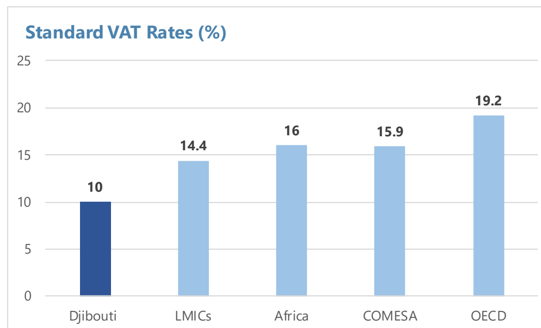
Personal Income Tax brackets		Rate
0	30,000	2%
30,000	50,000	12%
50,000	150,000	15%
150,000	300,000	22%
300,000	600,000	25%
600,000	1,000,000	30%
1,000,000	2,000,000	35%
2,000,000 and more		40%

Source: art. 15 of the general tax code

Figure 3. Djibouti: Statutory Corporate Income Tax Rates



Sources: IMF EcOS Database (Internal)



Source: IMF ECOS database (internal)

9. **Indirect taxes include the value added tax (VAT) and customs duties, with targeted excise taxes in a complementary role**. VAT applies at a standard rate of 10 percent to businesses with turnover exceeding DJF 20 million (USD 112,381) or DJF 10 million (USD 56,191) for services. This rate is noticeably lower than what is typically observed across Africa, where the average VAT rate is 16 percent.[2] Despite being a member of the Common Market for Eastern and Southern Africa (COMESA), Djibouti has yet to implement the COMESA common external tariff. Djibouti instead relies on an internal consumption tax (*taxe intérieure de consommation* or TIC), which acts as the country's customs tariff policy in all but its name. Lastly, excise taxes are levied on several different products, with khat being the single most important revenue raiser.

10. **Special tax regimes play an important role in the tax landscape.** The two most important—the Free Zone Code and the Investment Code—offer generous tax preferences, including income tax holidays of up to 50 years (Table 2). Tax preferences are also at times conferred through taxpayer-specific agreements, which do not appear necessarily legislated and could be adopted through ministerial decrees for example.

[2] Moreover, unlike many of its peers, Djibouti does not have a reduced VAT rate.

Table 2. Djibouti: Fiscal Exemptions Granted by Incentive Regimes

Fiscal advantage	Investment code Regime A	Investment code Regime B	Free Zone Regime	Foreign Military Forces
Exemption of TIC	X	X		
Exemption of the tax on business profits		X		
Exemption of the property tax		X		
Exemption of registration rights		X		
Exemption of all direct or indirect taxes (except the wage tax)			X	
Exemption of all direct or indirect taxes for the payment of an annual fee				X

Sources: Tax Code and Conventions.

11. Djibouti's tax base is narrow, and the taxpayer compliance rate is low across main tax types. Djibouti's generous tax exemption regimes have significantly eroded the taxpayer base. The number of registered taxpayers for the core taxes (business profit tax, pay-as-you-earn, and VAT) is low compared to that of countries of comparable population (e.g., Eswatini, Malawi, Mauritius, and Trinidad and Tobago).[2] In 2021, less than 60 percent of the registered business profit tax and VAT payers complied with their filing and payment obligations.

12. Revenue administration reform initiatives have been insufficient. A National Tax Forum in 2015 reviewed the weaknesses of the tax system and recommended 42 measures to modernize revenue administration. This was followed in 2019 by a Tax Administration Diagnostic Assessment Tool (TADAT)[4] evaluation which identified the strengths and weaknesses of the Djiboutian tax administration system. Reforms have, however, lagged behind. Key reforms so far include the commencement of the implementation of IT systems for tax and customs administration (SIGTAS and ASYCUDA World respectively), and the establishment of a single taxpayer registration window. Despite these commendable initiatives by the General Directorate of Taxation (Direction Générale des Impots - DGI) and the General Directorate of Customs (Direction Générale des Douanes - DGD) more work is needed to achieve an adequate level of modernization.[5]

13. Core tax processes continue to be manual and cumbersome. Delayed implementation of SIGTAS continues to hamper the tax administration's journey to modernization. Filing and payment

[3] For example, in 2022, Eswatini reported 2,616 corporate income tax registered taxpayers while Djibouti reported 804.

[4] TADAT aims to provide a standardized means of assessing the health of key components of a country's tax administration system and its level of maturity in the context of international good practice. www.TADAT.org.

[5] See Public Expenditure and Financial Accountability Report https://www.pefa.org/sites/pefa/files/2023-07/DJ-Mar23-PFMPR-Public%20with%20PEFA%20Check.pdf.

processes remain largely manual, resulting in redundant and ineffective administrative procedures and high compliance costs.

The Revenue to GDP Ratio Has Substantially Declined Over the Last Decade, and the Gap in Revenue Performance Vis-à-vis Peers Has Increased

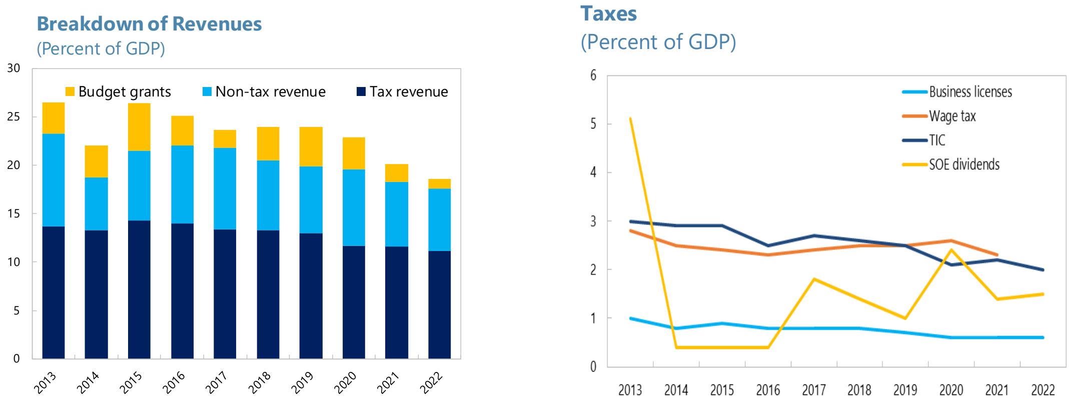
14. Total revenues over GDP decreased from 26.5 percent in 2013 to 18.6 percent in 2022. This decrease was driven by declines in all sources of revenues, although their extent varies significantly across sources. Revenues from grants went from 3.2 percent to 1 percent of GDP, after a quite volatile evolution including a peak at 4.9 percent of GDP in 2015. Tax revenues declined from 13.7 percent to 11.2 percent of GDP, with a peak at 14.3 percent in 2015. Non-tax revenues recorded a steeper decline, from 9.6 percent to 6.5 percent of GDP (Table 3 and Figure 4)

Table 3. Djibouti: Evolution of Some Sources of Revenues, 2013–2022
(Percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenues and grants	**26.5**	**22.1**	**26.4**	**25.1**	**23.7**	**23.9**	**23.9**	**22.9**	**20.1**	**18.6**
Revenues	**23.3**	**18.7**	**21.5**	**22.0**	**21.8**	**20.5**	**19.9**	**19.6**	**18.3**	**17.6**
Tax revenues	**13.7**	**13.3**	**14.3**	**14.0**	**13.4**	**13.3**	**13.0**	**11.7**	**11.6**	**11.2**
Direct taxes	***6.3***	***5.8***	***6.2***	***6.0***	***5.6***	***5.5***	***5.5***	***5.1***	***4.9***	***5.0***
Business license fees	1.0	0.8	0.9	0.8	0.8	0.8	0.7	0.6	0.6	0.6
Wage tax	3.1	2.8	2.5	2.4	2.3	2.4	2.5	2.5	2.6	2.3
BIC-BNC-PVI	0.3	0.3	0.3	0.3	0.4	0.3	0.2	0.2	0.2	0.2
Corporate Income Tax	1.4	1.3	1.8	1.8	1.5	1.4	1.4	1.2	1.1	1.3
Indirect taxes	***6.6***	***6.7***	***7.2***	***7.0***	***7.0***	***7.1***	***6.9***	***6.1***	***6.2***	***5.7***
TIC	3.0	2.9	2.9	2.5	2.7	2.6	2.5	2.1	2.2	2.0
VAT	2.3	2.4	3.1	3.1	3.0	3.1	3.1	2.6	2.6	2.4
Other taxes	***0.8***	***0.8***	***0.9***	***1.0***	***0.8***	***0.7***	***0.5***	***0.5***	***0.5***	***0.4***
Non-tax revenues	**9.6**	**5.4**	**7.2**	**8.0**	**8.4**	**7.2**	**6.9**	**7.9**	**6.7**	**6.5**
SOE dividends	5.1	0.4	0.4	0.4	1.8	1.4	1.0	2.4	1.4	1.5
Tax on Domestic Fuel	0.6	0.7	1.6	1.2	0.9	0.6	0.8	1.1	0.8	0.1
Grants	**3.2**	**3.3**	**4.9**	**3.1**	**1.8**	**3.4**	**4.0**	**3.4**	**1.8**	**1.0**

Source : Authorities' data and IMF staff calculations.

Figure 4. Djibouti: Evolution of Some Sources of Revenues, 2013–2022

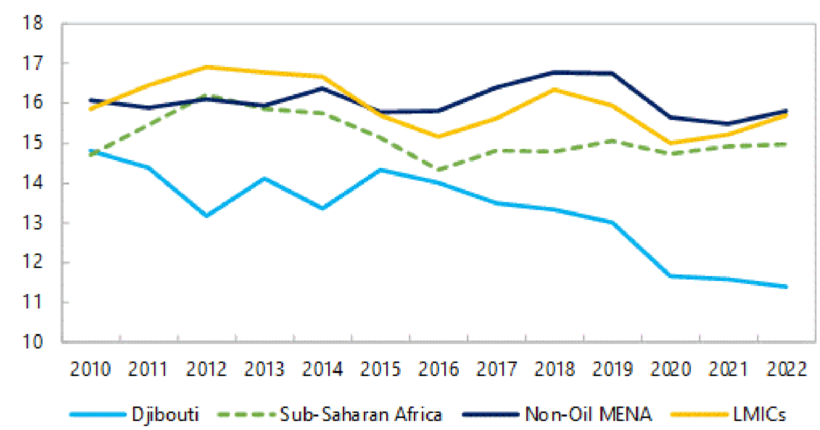


Source: Authorities' data and IMF staff calculations.

Sources: Authorities' data; and IMF staff calculations.

15. At 11.2 percent, Djibouti's tax-to-GDP ratio is several percentage points below averages observed in peer groups, including other LMICs (16 percent), non-oil Middle East and North Africa (MENA) countries[6] (15.9 percent) and SSA countries (15.1 percent) (Figure 5).

Figure 5. Djibouti: Tax Revenue Performance (Percent of GDP)



Source: World Economic Outlook (WEO)

16. Djibouti's tax ratio is also below the 12.75 percent of GDP tipping point identified by empirical literature as the point above which countries experience significantly better outcomes in terms of economic growth and development.[7] Furthermore, in view of the volatility of tax-to-GDP ratios, it is generally recommended for countries with low tax-to-GDP ratios like Djibouti to aim for

[6] This group is comprised of Egypt, Jordan, Lebanon, Mauritania, Morocco, and Tunisia.

[7] Gaspar, Vitor, Laura Jaramillo, and Philippe Wingender, 2016, "Tax Capacity and Growth: Is there a Tipping Point?" IMF Working Paper No WP/16/234 (Washington: International Monetary Fund).

levels of about 15 percent over the medium-term. At the same time, Djibouti has significant room to increase fiscal space by implementing the following reforms: (i) improving SOE governance to mobilize dividends from profitable SOEs and reduce the need for subsidies of others, (ii) facilitating formalization to broaden the tax base, (iii) undertaking a deep tax reform anchored on medium-term goals, and (iv) strengthening the tax and customs administrations.

D. Improving SOE Governance to Mobilize SOE Dividends

17. SOEs are central in Djibouti's economy. A vast majority of economic activity in the country is undertaken by companies which are either fully or partially state-owned. The Djiboutian state is a central shareholder in the various entities which compose and revolve around Djibouti's ports. Furthermore, it fully owns utilities and telecommunications providers ranging from water, electricity, and telecoms, as well as the train company (*Société Djiboutienne de Chemins de Fer*). It also owns one-third of the largest bank in the country, *Banque pour le Commerce et l'Industrie Mer-Rouge*, a subsidiary of French banking group BRED (which is a majority owner). This has largely crowded out private sector activity in the country's main growth sectors, with its operations largely limited to the services sector, particularly the financial sector. At the same time, SOE governance is weak, especially considering their outsized role.

Key Djibouti SOEs
100 percent Ownership
Société de Gestion du Terminal à Conteneur de Doraleh
Société de Gestion de la Jetée du Terminal Pétrolier de Doraleh
Doraleh Multipurpose Port
Port de Djibouti SA
Djibouti Damerjog Industrial Development
Djibouti Shipping Company
Djibouti Ship Repair Yard
Port du Goubet
Port de Tadjourah
Office National de l'Eau et de l'Assainissement de Djibouti
Electricité de Djibouti
Djibouti Télécom
Société Djiboutienne de Chemins de Fer
Partial Ownership
Port de Djibouti SA (66 percent)
Djibouti Ports Corridor Road (65 percent)
Great Horn Development Company (51 percent)
International Djibouti Industrial Parks Operations (40 percent)
Banque pour le Commerce et l'Industrie Mer-Rouge (33 percent)
Source: Authorities' data.

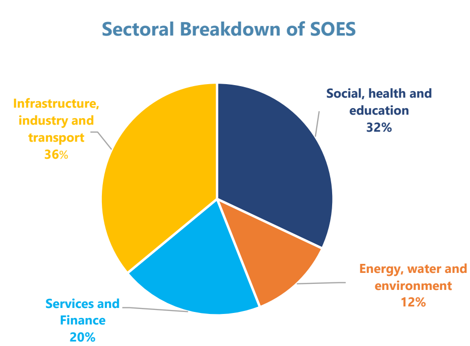
18. SOE governance impacts SOE financial performance. Combining governance indices with measures of SOE performance in a composite index to explore the relationship between SOE performance and governance measures in the Middle East and Central Asia region shows that a higher composite index score is associated with higher return on assets of SOEs (IMF, 2021). In particular, a higher financial oversight index is associated with a higher share of SOEs operating at a profit in a given country. Corporate governance standards like the OECD guidelines on corporate governance of SOEs (OECD, 2015a) have been associated with improved management and oversight of SOEs and helped in enhancing their transparency and accountability (OECD, 2020). The IMF has discussed the legal, institutional and procedural arrangements that governments need to oversee the financial operations of their public corporations to ensure accountability for their performance while managing the fiscal risks they present (IMF, 2016).

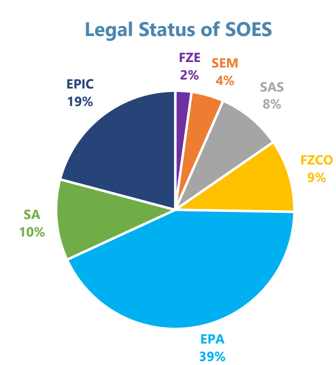
19. SOE governance necessitates a clear ownership policy. The OECD suggests that the ultimate purpose of state ownership of enterprises should be to maximize value for society (OECD, 2015b). To that end, governments need to know what they own by establishing comprehensive lists of SOEs on the one hand and to have a clear ownership policy on the other hand (IMF, 2021).

20. Dividend policies are also relatively widespread across the Middle East, North Africa and Central Asia region (IMF, 2021). They can facilitate revenue stability, and thereby support medium-term fiscal budgeting, while also ensuring that SOEs have visibility on their resources.

21. Djibouti lacks an ownership policy, or a dividend policy, and oversight of SOEs is dispersed. There is a large number of SOEs acting in numerous areas and under different legal statuses (Figure 6). As of February 2024, the Executive Secretariat in charge of the State Portfolio (*Secrétariat Exécutif chargé de la Gestion du Portefeuille de l'Etat*—SEPE), had mapped 77 SOEs by sector (Energy, Water, Environment ; Infrastructure, Industry, Transport; Services and Finance; Social, Health, Education) and by legal status (*Etablissement Public Administratif – EPA, Etablissement Public à Caractère Industriel et Commercial – EPIC, Société d'Etat – SA, Société par Actions Simplifiée—SAS, Société d'Economie Mixte— SEM, Société à Responsabilité limitée de Zone Franche or Free Zone Company—FZCO and Entreprise unipersonnelle à responsabilité limitée de la Zone Franche or Free Zone Establishment - FZE*). These SOEs report to different ministries, generally depending on the sector in which they are active, except for SOEs placed under the Sovereign Wealth Fund, which are under the supervision of the Presidency of the Republic. Auditing bodies vary and include the *Inspection Générale de l'Etat* (IGE), the *Inspection Générale des Finances* (IGF) and the *Direction Générale de la Comptabilité Publique (DGCP)*. A 2022 law aiming to consolidate EPAs by either merging some or reallocating their responsibilities to relevant ministries did not reach its objectives. As a result, the authorities are contemplating a second wave of consolidation, to rationalize the SOE landscape and facilitate an efficient and effective oversight.

Figure 6. Djibouti: Breakdown of SOEs by Sector and Legal Status





Source: Authorities' data and IMF staff calculations.

22. As a result, SOEs lack transparency and accountability. Djibouti scored 3 out of 6 on the 2022 Country Policy and Institutional Assessment indicator for transparency and accountability in the public sector.[8] In particular, the large majority of SOEs do not produce their financial accounts on time nor do they share them with their supervisory body. At the same time, the absence of timely production or sharing of financial accounts does not bear any consequence. Notably, it does not prevent SOEs from getting their budget approved or from receiving subsidies. As of February 2024, the SEPE had received financial accounts from only 14 SOEs out of the 77 it had listed, sometimes from 2018 to 2022, sometimes only for 2021 or 2022.

23. Significant improvements to SOE governance were included in the Code of Good Governance of SOEs adopted in 2016. The code focused on improving key areas including: (i) fostering a culture of result, performance and transparency, and effective control by the government, (ii) redefining and clarifying the principal functions and missions of the state, the board and senior management, as well as the framework in which these are to be exercised, (iii) establishing governance criteria including efficiency, effectiveness, transparency, integrity and accountability, (iv) defining the state's roles as a strategist, a shareholder, and a controller, together with performance contracts between the state and SOEs. It defined relevant control and monitoring mechanisms. The Code also included detailed provisions on board autonomy, senior management, specialized committees of the board, rendition of accounts, relationships between SOEs and ministries, relationships between SOEs and the Parliament or the Court of Audit, and the body of coordination of the governance of SOEs.

24. However, implementation of the Code remains lagging. After significant delays in the publication of the decrees, a law was adopted in July 2021 creating the Executive Secretariat in charge of the Portfolio of the State (SEPE). While in theory it has been given a central role in evaluating, managing, and monitoring the performance of the state's financial assets, in practice the SEPE lacks resources to adequately fulfill its mission.

25. This situation was worsened by the creation of the Sovereign Wealth Fund (SWF) in 2020. The SWF was created with the objective of developing investment projects supporting the diversification of the economy, in partnership with international investors. In practice, it holds the shares of the state in Great Horn Investment Holdings, the investment arm of Djibouti Ports and Free Zone Authority (DPFZA) and Djibouti Télécom, probably the two most profitable SOEs in the country. It is also planned that it will own Electricité de Djibouti, another profitable SOE. The provisions of the Code of Good Governance of SOEs do not apply to the SWF, which was placed under the supervision of the Presidency of the Republic. The SWF is also stipulated to receive 20 percent of the revenues from the military bases leases (although in recent years these have been halted for lack of fiscal space).

[8] Transparency, accountability, and corruption in the public sector assess the extent to which the executive can be held accountable for its use of funds and for the results of its actions by the electorate and by the legislature and judiciary, and the extent to which public employees within the executive are required to account for administrative decisions, use of resources, and results obtained. The three main dimensions assessed here are the accountability of the executive to oversight institutions and of public employees for their performance, access of civil society to information on public affairs, and state capture by narrow vested interests.

26. Against this backdrop, the state's knowledge and management of its assets remains weak, hampering its ability to mobilize dividends from profitable SOEs, while limiting the need for subsidies of others. In the 2023 PEFA, Djibouti received the score D+ for the management of its assets. The drivers of the score C for the subcategory management of financial assets include (i) the lack of a report on the performance of shares in SOEs and dividends perceived, (ii) no comprehensive monitoring of the financial relationships between the state and SOEs (subsidies, transfers, parafiscal taxes, taxes, dividends, etc), and (iii) the lack of the notion of financial performance.

27. Accelerating governance improvements would thus be key. As a first step for the state to be able to better mobilize dividends, improving the information and monitoring would be essential. Introducing adequate penalties for SOEs which do not submit financial statements would help increase compliance. Empowering the SEPE with strong political buy-in and adequate resources would help allow it to fully meet its mandate.

E. Facilitating Formalization to Broaden the Tax Base

28. The share of the working age population in formal employment is low. In 2017, when the latest employment survey was conducted, the working age population stood at about 628,000 people (out of a population of around 950,000). The active population was estimated to represent 44.7 percent of the working age population, i.e. about 280,000 people. 23.7 percent of the working age population had a job, i.e. around 149,000 people. At the same time, 67,659 people were registered with social security (Caisse Nationale de Sécurité Sociale - CNSS) as employed (*salariés*).

29. Against this backdrop, a significant share of the population is in informal employment. The 2016 survey on the informal sector conducted by the Direction of Statistics and Demographic Studies (*Direction de la Statistique et des Etudes Démographiques – DISED*) assessed that 20 percent of the active population was in informal employment, three quarters of which in Djibouti ville. 73.7 percent of these units would be led by a woman. They would be active in the commercial sector (64.7 percent), services (20.1 percent), industrial activities (11.5 percent) and the primary sector (3.7 percent). 90 percent of the units would be self-employed with only 8.5 percent of units having employees, which would generally be family members.

30. The very large majority of these informal units do not pay taxes while their value added may not be negligible. The 2016 survey assessed that in 2015 these units would have had a total turnover of DJF 89.9 billion (USD 510 million), a total production of DJF 69.7 billion (USD 390 million), a value added of DJF 60.9 billion (USD 340 million or 14 percent of 2015 GDP) and a gross operating surplus of DJF 52.3 billion (USD 290 million). Most of them (85.1 percent) were not registered with public bodies (business registry, single taxpayer registration number – NIF or social security). Reasons advanced for not seeking a single taxpayer registration number included that it was considered not compulsory (52.3 percent), the cost of registration (23.5 percent), the complexity of procedures (17.2 percent) or the refusal to cooperate with the state (4.3 percent). The very large majority of informal units claimed that they did not see any benefit in getting formal.

31. Facilitating formalization could support revenue mobilization. Addressing the lack of understanding of the benefits of formalization would be key. That could be achieved through campaigns raising awareness on the benefits provided by social security. Simplifying procedures, through a one stop shop for business registry, social security and single taxpayer number for instance, could also be helpful.

32. Some tax policy measures can help rebalance the cost-benefit trade-off towards formalization (IMF, 2022). They include simplified tax regimes for small businesses, more efficient VAT "chains of compliance" for formal firms, a lower "net formalization cost" of labor and better enforcement.

33. Digitalization can also help reduce informality (IMF, 2022). Digitalization facilitates identification and verification of individuals and firms on the one hand and simplifies requirements on the other hand. Furthermore, digital payments contribute to financial inclusion (G20, 2018), while decreasing the use of cash informal businesses rely on (Rogoff, 2016).

F. Enhancing Revenues Through Sound Tax Policy

34. A holistic long-term vision towards revenue mobilization would support durable reforms. Recent measures have improved the tax system at the margin but left core issues—such as investment tax incentives and the poor performance of the VAT—largely unaddressed. There is an important window of opportunity to design and implement a holistic plan for revenue mobilization, with well-timed and consistent implementation.

35. The bulk of tax revenues in Djibouti originate from customs duties, value added tax (VAT), and the wage tax. The VAT and the wage tax each raise about 2.3 percent of GDP in revenues, making them the largest single contributors. Custom duties account for about 2 percent of GDP in revenue. Together, these three taxes account for close to two-thirds of total tax revenues. The remaining one-third comes predominantly from the corporate income tax (1.5 percent of GDP), excise taxes (1.4 percent of GDP), and business license fees[9] (0.6 percent of GDP).

Breakdown of Tax Revenues

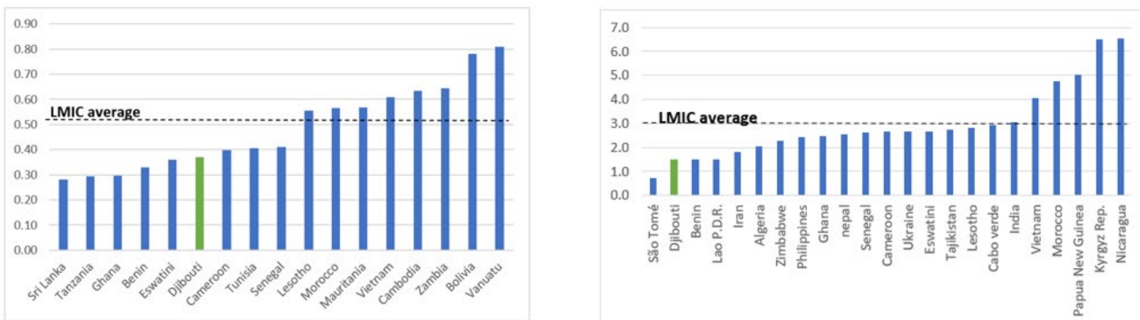
Sources: Leduc and Laporte (2023)

[9] Formally known as the *contribution des patentes*.

36. Revenue productivity from the VAT and the corporate income tax appear significantly below potential (Figure 7). Despite the importance of the VAT in Djibouti's tax mix, its revenue performance remains considerably below potential as evidenced by a c-efficiency ratio of only 0.37.[10] Djibouti could increase revenues by as much as 0.9 percent of GDP by implementing legislative and administrative reforms which would put its c-efficiency on par with the average for lower middle-income countries (0.52). At only about 1.5 percent of GDP, revenues from the corporate income tax[11] also stand out as being comparatively low relative to average corporate income tax revenues in sub-Saharan Africa and across lower middle-income countries (both around 3 percent of GDP).

Figure 7. Djibouti: Revenue Productivity of the VAT and Corporate Income Tax

VAT C-Efficiency Rations in Select LMICs | **Corporate Income Tax Revenues (% GDP)**



Source: FAD WoRLD Database (internal), FADTP Rates Database (internal), and WEO

Source: Wordl Economic Outlook (WEO)

Anchoring Tax Policy Reform Within a Medium-Term Agenda

37. Clear political leadership and commitment to a medium-term tax reform agenda could offer a path to a sustainable increase in tax revenues. A guiding principle could be to increase tax revenues incrementally to eventually reach 15 percent of GDP, thereby supporting Djibouti's developmental goals while providing some wiggle room. The overall package could be a combination of incremental reforms (i.e., relatively minor amendments to existing taxes) together with more structural reforms. It is important to recognize that while the overall package should support revenue mobilization, each measure individually need not necessarily be revenue enhancing. Strong political buy in, together with technical expertise to advise the executive and motivate the plan to various stakeholders will be foundational for its success.

38. Beyond raising revenue, such an agenda could also help improve the "quality" of the revenue framework. Sound tax policies are those which allow the government to raise a given amount of revenue (or achieve a desired level of income redistribution) with the least distortions to the economy. Aside from a few mostly notional cases[12], taxes will generally induce economic

[10] C-efficiency is defined as the ratio between VAT revenues (numerator) and the product of private consumption and the standard VAT rate (denominator). It can be interpretated as the share of revenues effectively collected against revenue potential computed as a standard rate applying to all domestic consumption.

[11] Djibouti's corporate income tax applies to both natural and legal persons engaged in business activities and is thus slightly broader in scope than a typical corporate income tax which applies only to the latter.

[12] Such as a pure rent tax or lump-sum taxes.

distortions and the objective should be to minimize these distortions given the significant impact they can have on social welfare and economic growth. Fairness, neutrality, administrability, ease of compliance, and international competitiveness are among the other useful criteria that can guide the implementation of sound policy reforms within the medium-term agenda. As is the case with most developing countries, there appears to be ample scope for Djibouti to boost revenue in a way that is both inclusive and growth friendly.[13]

Options for Incremental Reforms

39. High priority could be given to improving the revenue productivity and neutrality of the VAT. The VAT is efficient at raising large amounts of revenue, but not cost-effective in achieving redistribution which is best achieved through targeted social programs and a progressive personal income tax.[14] Therefore, the use of exemptions as a social tool is not recommended and exemptions should strictly be limited to basic foodstuffs (i.e., those which take up a larger share in lower-income individuals' budgets) and margin-based financial services given practical challenges. Exemptions for other supplies for which high-income individuals dedicate a larger share of their income—such as private education, private healthcare, cost-based financial services, art, water utility and electricity—do not appear justifiable. Moreover, the use of a fixed tax base value for khat which is set artificially low is inconsistent with the levy of excise taxes on this product given social concerns linked with its consumption.

40. It is not good practice to use VAT exemptions as tax incentives for businesses. With proper design, VAT is ultimately levied only on final domestic consumption and does not distort production. A key feature of the VAT is that revenues are secured by being collected throughout the value chain (unlike a retail sales tax). VAT exemptions offered as investment incentives—such as those for imports by contractors and new suppliers in select industries—add considerable administrative burden in a context of low capacity, raise important concerns over revenue leakage, and can help sustain a large informal sector. A precondition for the successful repeal of these exemptions is the efficient processing and prompt repayment of excess credits, which will necessitate revisiting current arrangements.[15] Other exemptions, such as the one offered for agriculture and fishery, undermines the competitiveness of larger domestic suppliers competing with imports since foreign firms are zero-rated in their country of origin. For smaller domestic suppliers operating in these sectors, the VAT threshold will, in any case, ensure that they remain *de facto* exempt.

41. A review of the wage tax would help determine whether it achieves redistributional objectives without significantly distorting labor market decisions. The wage tax generates a comparatively large amount in revenue, such that focus could be placed on ensuring fairness and

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[13] See, for example, De Mooij et al., 2020, "Tax Policy for Inclusive Growth after the Pandemic", IMF Special Series on COVID-19, Fiscal Affairs Department (Washington: International Monetary Fund).

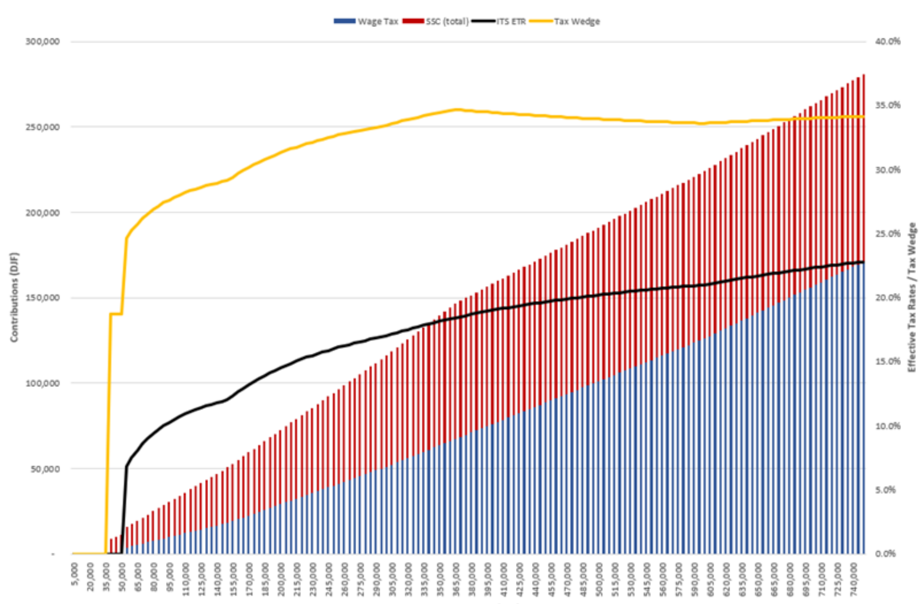
[14] [Inequality and Fiscal Policy (imf.org)]

[15] To ensure availability of funds, many countries earmark a share of VAT revenues collected at customs to a dedicated escrow account at the central bank. Such an account exists in Djibouti but is not systematically funded.

investigating the extent to which the wage tax may contribute to persistently high unemployment. Analysis of the distribution of wages in the public and private sectors would help inform whether the current brackets and tax rates are indeed appropriate. Although exemptions from the wage tax are limited, the merits of exempting pension income may need to be revisited as this likely proves highly regressive in a country where only 10 percent of the working age population is formally registered.

42. Social security contributions can influence work incentives and labor market outcomes, especially if there is a weak link between contributions and benefits.[16] In Djibouti, social security contributions add up to 21.7 percent to employment costs over a broad range of incomes. As evidenced by Figure 8, while wage tax liability appears negligible for lower-income individuals, social security contributions add considerable costs to formal employment even at low earnings. For instance, at a monthly salary of 100,000 DJF, the wage tax liability is only 10,500 DJF but social contributions add up to 21,700 DJF. Djibouti's tax wedge reaches 34 percent at a monthly salary of 325,000 DJF, which is for comparison about the same as the average tax wedge across countries from the Organisation for Economic Co-operation and Development (OECD).[17] It appears unlikely, however, that Djibouti's social programs provide comparable benefits to those observed on average across OECD countries.

Figure 8. Djibouti: Wage Tax, Social Security Contributions and Tax Wedge



Sources: IMF calculations based on information in Djibouti's tax code and https://www.ssa.gov/policy/docs/progdesc/ssptw/

[16] If the link between contributions and benefits is weak, social security contributions largely act as additional taxes on labor for which revenues are earmarked toward specific expenditure programs. See, for instance: Tax by design | Institute for Fiscal Studies (ifs.org.uk)

[17] In 2022, the average tax wedge in the OECD was 34.6 percent of GDP. See Tax - Tax wedge - OECD Data

43. Extending the income tax base to capital income, including interest and dividends, would generate revenue and improve fairness. Interest income and dividends are currently largely exempt from tax, be they received by an individual, an entity, or a non-resident.[18] It appears unlikely that these exemptions have a meaningful impact in reducing the cost of capital and in generating additional investment in Djibouti.[19] At the same time, these exemptions reduce revenues, undermine progressivity, and raise opportunities for tax base erosion. The exemption for interest income raises concerns for the latter, as it is a deductible expense for the payor if incurred in the context of a business undertaking. Taxation at a moderate flat rate would alleviate these concerns while raising revenues in a progressive manner. A similar conclusion emerges for dividends, considering that they predominantly benefit high-income individuals and can be used to circumvent capital gains tax. Any concerns over double taxation can be alleviated through a participation exemption and reliance on a moderate rate.

44. A higher corporate income tax rate may be justified for some sectors if local economic rents are involved. If market conditions allow firms in given sectors to generate above normal profits, taxing such profits would increase revenues without distorting economic activities. While rent taxes are most commonly used for extractive industries, they are at times also applied in other regulated sectors such as banking and telecommunications. Given the presence of very few large formal businesses in these sectors, it would appear administratively straightforward to mobilize additional revenues from these firms should they be deemed to generate super-profits.

45. Tax avoidance poses a significant threat to the income tax base. Base erosion and profit shifting—through excessive leveraging, transfer mispricing, treaty abuse[20], or other sophisticated techniques—can significantly undermine the integrity of the income tax base. In addition to revenue leakage, tax avoidance by multinationals (and perhaps domestic groups with members benefiting from tax holidays) place smaller local business at a competitive disadvantage, thereby potentially causing harm to their growth. It is important to ensure that base protection measures are sufficiently robust and well-targeted to minimize these risks while also avoiding placing undue burden on legitimate business undertakings.

46. Djibouti could explore new excise taxes. Best practice for excise tax policy prescribes that only a limited number of products should be singled out, particularly those generating externalities or for which demand is relatively inelastic.[21] Among goods currently subject to excises in Djibouti,

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[18] Budget 2024 introduced a 5 percent tax on dividends distributions by Djiboutian corporations. However, the provision includes several exemptions, including for dividends below DJF 10 million and for dividends received that will be reinvested in Djibouti.

[19] Some of the increased savings is invested overseas or in larger firms with access to global financial markets for which a marginal increase in the supply of capital has no meaningful impact on their investment decisions.

[20] Michielse, G. and S. Leduc, 2021, "Are Tax Treaties Worth It for Developing Countries?", Chapter 8 in Corporate Income Taxes under Pressure Why Reform Is Needed and How It Could Be Designed (Washington: International Monetary Fund).

[21] Sijbren Cnossen, 2020, "Excise Taxation for Domestic Resource Mobilization", CESifo Working Paper No. 8442, available at SSRN: https://ssrn.com/abstract=3657978 or http://dx.doi.org/10.2139/ssrn.3657978

tobacco, alcohol, gasoline, khat, plastics and sugar-sweetened beverages appear justified.[22] In exploring avenues to generate additional tax revenues, consideration could be given to introducing a new excise tax on motor vehicles,[23] and possibly telecommunication services.[24]

Pursuing Reforms into the Medium-Term

47. A fundamental overhaul of tax incentives could give a small open economy like Djibouti a modern incentive framework which is competitive for all investment. Given the high mobility of capital internationally, tax competition pressures are understandably high. While excessively generous in some areas, Djibouti's tax system appears excessively punitive in others. This results in a highly complex, distortionary, and inequitable system. In a context of fiscal consolidation, it appears critically important to avoid inefficient incentives. In particular, cost-based incentives—such as accelerated depreciation which allows investors to recoup investment expenses at a faster pace, investment allowances or tax credits which can target strategic sectors, and a more generous loss carryforward period—have proven more effective and cost-efficient at stimulating investment than profit-based incentives (tax holidays and reduced tax rates), which would gain from being phased out.[25] It is also best practice to consolidate tax incentives within the general tax code in a system that is designed to be broadly competitive and growth-friendly[26], as opposed to one which grants exceedingly generous incentives on a selective or discretionary basis within and outside the tax law (including in the Investment Code and through ministerial decrees). This approach best promotes neutrality, fairness, simplicity, transparency, and good governance.

48. Several profit-insensitive taxes raise effective taxation—especially on low-margin businesses—and also merit reconsideration as authorities pursue inclusive growth. The most important of these are custom duties (*taxe intérieure de consommation - TIC*) and business license fees (*patentes*). Together, these taxes raise about 2.6 percent of GDP in revenue and hence hold considerable importance within Djibouti's tax mix. However, these taxes are highly distortionary and undermine the competitive investment-friendly climate that Djibouti is trying to establish. The TIC applies rates that can reach 23 percent on some capital goods; this discourages investment as it raises the return on capital needed to make projects financially viable. Such provisions can help sustain a culture of derogatory tax regimes to promote investment. A better alternative would be to reduce the TIC on all capital goods, even to zero if possible. Tax liability under the *patente* appears

[22] Although the several different levies on khat would gain from being consolidated, and revenue earmarking is generally not recommended.

[23] These excises predominantly serve as a luxury tax. They are not intended to address environmental or health objectives (best addressed by an excise on petroleum products) or other externalities linked with road use (such as congestion, which is best addressed by a congestion levy).

[24] This will need to be considered alongside a potential corporate income tax surcharge, with the latter being desirable if deemed appropriate. See [Taxing Telecommunications in Developing Countries (imf.org)](#) for an in-depth discussion.

[25] https://www.imf.org/external/np/g20/pdf/101515.pdf

[26] A reduction in the headline corporate income tax could even be contemplated in a context where tax holidays are phased out.

arbitrary, excessively complex, and distortionary. It would appear preferable to set the business license fee to a single low nominal amount for all businesses and rely on the corporate income tax to share in the profits generated by the private sector.[27] To help tackle informality, a new simplified presumptive income tax regime could be introduced for small traders.

49. It would be prudent to ensure that positive economic spillovers from the Free Zone truly justify revenue foregone and that current institutional arrangements are sustainable. If the Free Zone is deemed predominantly beneficial, it may nevertheless prove justified to limit the scope of eligible activities to internationally mobile activities with focus on exports. This would help minimize risks of mere relocation of activities originating from Djibouti or drawn thereto by location-specific considerations. Furthermore, the 50-year tax holiday appears excessive—for instance, countries such as Kenya and Ghana offer 10-year holidays, Madagascar offers 2 to 5 years, and Morocco 5 years[28]. A thorough review of the Free Zone would also examine institutional elements, including an assessment of the current framework for government oversight over the Free Zone Authority and the appropriateness of its royalty-based funding scheme.

50. The holding of real property (wealth) and income derived from the letting of such property (rents) warrant the levy of distinct taxes. The current system combines the two in a single tax resulting in an opaque and complex framework which leads to questionable outcomes, such as an exemption from property tax where rental payments are involved and the use of a distinct progressive schedule even if rental income is earned by a corporation subject to the corporate income tax. Taxation of the holding of real property and the earning of rental income would benefit from being untangled. This would necessitate the creation of a new tax on rental income for individuals, the repeal of the exemption of rental income from the corporate income tax, and the application of a recurrent tax on immoveable property irrespective of whether the property is rented, temporarily vacant, or owner-occupied.[29] The merits of exempting newly-built properties could concurrently be revisited considering revenue needs, its probable regressive nature, and the desire to nurture a tax compliance culture.

Sound Institutions: A Foundation for Success

51. A dedicated tax policy unit (TPU) would provide invaluable support to ensure that tax reform proposals are carefully assessed, quantitatively analyzed, and openly debated.[30] Like many other developing countries, Djibouti lacks a dedicated TPU which can provide decisionmakers with analysis and advice on various tax reforms. Even a small TPU—comprised predominantly of

[27] The integrity of the business income tax base should remain protected by the minimum tax, which helps secure revenues in a context of low compliance and weak administrative capacity.

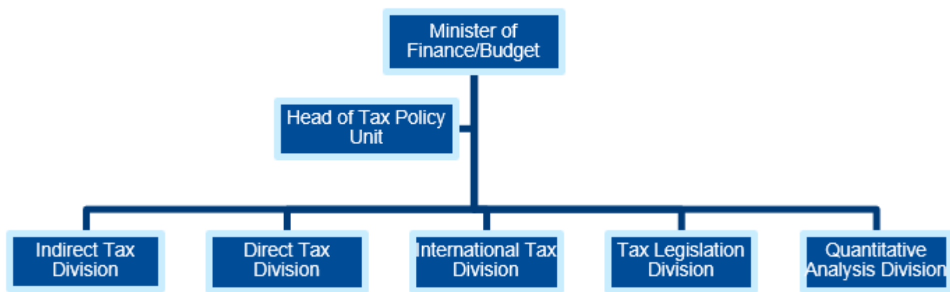
[28] Source: PwC tax summaries and orbitax.

[29] Real property taxation is consistent with a progressive and growth-friendly reform that mobilizes additional revenue. See for example: Organisation for Economic Cooperation and Development, "Tax and Economic Growth," Economic Department Working Paper No. 620, Paris, 2008.

[30] Martin Grote, 2017, "How to Establish a Tax Policy Unit", IMF How to Notes, Fiscal Affairs Department (Washington: International Monetary Fund).

economists and a few lawyers—can provide valuable support in the design of sound tax policies, so long as its analysis proves sufficiently resourceful to influence ongoing debates.[31] Over time, the gradual expansion of the TPU will allow it to take on more responsibilities (such as the yearly publication of a tax expenditures report) and facilitate proactive—as opposed to purely reactive—assessment of possible reform options. Figure 9 illustrates a stylized structure for a mid-size TPU, which could include anywhere from 10-15 individuals.

Figure 9. Djibouti: Stylized Organigram for a Tax Policy Unit



52. Improving analytical capacity in tax policy analysis and securing availability of quality taxpayer data would greatly support the design of appropriate reforms. With or without a TPU, it is critical that tax reform assessments be driven by objective fact-based analyses by individuals familiar specialized in taxation.[32] This would require prioritizing internal or external training on tax policy (including through capacity development from development partners) and securing availability of good taxpayer data that can feed into quantitative analyses that support sound decision-making. While it appears unlikely that such investments will yield short-term gains, medium-term benefits make them nonetheless worthy of short-term action.

53. The fostering of good governance stands as a precondition for the successful implementation of reforms within a medium-term tax agenda. Strengthening oversight over public institutions (including state-owned enterprises) and ensuring strict adherence with the rule of law lay the core foundation for social and economic development and help build trust in the integrity of the executive, legislative, and judicial branches of government. Although good governance extends well beyond tax policy design, there are significant implications for it nonetheless. For instance, it is important to minimize room for discretion, which has been known internationally to raise opportunities for abuse and even possibly corruption. Instead, best practice

[31] Beyond the qualifications of individuals within the TPU, other factors influencing the value of its contributions include access to taxpayer data and its location within the organogram.

[32] Best practice would be for these individuals to be specialized in tax policy and for consultations to be held with relevant structures within the tax administration to ensure that operational constraints are fully taken into account.

calls for the use of objective tests that are clearly laid out directly within the law and strictly adhered to. Moreover, credibility of public institutions is best preserved when tax provisions are formally endorsed by the legislative branch and transparently reflected in the core tax law, not negotiated on a case by case basis by the executive branch (e.g., through ministerial decrees and/or taxpayer-specific conventions). It is critical that deficiencies in these areas be identified and addressed within (or alongside) the medium-term tax policy reform agenda. These changes will be foundational to ensure that sustained benefits will be reaped from tax policy reforms.

G. Building a More Efficient and Effective Tax and Customs Administration

Focusing on Reforms with High Revenue Potential

54. There is room for increasing revenue mobilization through revenue administration reform in Djibouti. Experience has shown that a comprehensive and sustained approach with multiple revenue administration measures could increase tax revenues (Akitoby et al, 2018). A reform package which includes measures to strengthen compliance risk management, enhance accountability and transparency, establish a large taxpayer office (LTO), and improve on-time filing of tax returns has proved to have a significant impact on tax revenue mobilization.[33] Indeed, using data from Malawi,[34] there is potential to increase tax revenue by at least 1.6 percent of GDP over a period of five years.[35]

55. Broadening the taxpayer base could help boost tax revenue. Ensuring that all businesses and individuals required by law to register are identified and accounted for by the tax administration is critical. Efforts already exist to collect information from the national business registration system and imports data from DGD. A more systemic approach to widening access and making greater use of data collected from third parties such as banks, the Social Security Administration, National Statistics Department, telecommunications, and electricity companies will be needed to ensure that vital third-party data is being received automatically and is used effectively for large-scale cross

[33] Adan, H., Atsebi, J., Gueorguiev, N., Honda, J., Nose, M. (2023). Quantifying the Revenue Yields from Tax Administration Reforms. IMF Working Paper, WP/23/231. International Monetary Fund, Washington, DC.

[33] The performance assessment report index is compiled as the equally weighted average of the nine TADAT performance outcome areas, which measures the strength of the tax administration across all practices and characteristics.

[35] Estimation of tax revenue yield has been carried out using a new Excel-based tool for tax administration analysis developed by FAD, the Tax Administration - Assessment and Yield Tool (TA-AYT). The tool uses data from the International Survey on Tax Administration (ISORA) to identify gaps in a country's tax administration capacity and systematically estimate the revenue yields from closing such gaps with tax administration reforms. It does this by, first, providing an overview of the overall tax administration strength and the state of different practices or characteristics of tax administration, while allowing for benchmarking comparisons. Second, it estimates revenue yields from tax administration reforms using a regression-based analysis and users' inputs on the potential reforms. Using the TA-AYT, we estimate cumulative revenue for Malawi, as back of the envelope estimates for Djibouti, from implementing the following key reforms - e-filing of the main taxes, automated risk profiling of the returns, use of automated third-party data, and expanding the tax register. The analysis shows a lower bound estimate of about 1.6 percent of GDP, cumulatively over five years.

checking to broaden the taxpayer base and develop and maintain a reliable and accurate taxpayer register.

56. Improving taxpayer compliance will be critical to mobilizing revenue in Djibouti. Djibouti's complex revenue administration system with low capacity is unlikely to promote voluntary compliance or support revenue mobilization. International experience shows that a balanced set of initiatives could achieve a big impact on improving taxpayers' compliance.[36] Measures to promote voluntary compliance in Djibouti could include (i) simplifying administrative procedures for return filing, reporting, and payment, (ii) implementing proactive taxpayer engagement and education programs to ensure that taxpayers have a clear understanding of their obligations and (iii) enhancing taxpayer services to reduce compliance costs. DGI's enforcement capabilities could also be improved. Early detection of non-compliance, sound and risk-based audit programs and effective penalty regimes are required to lift the level of tax compliance in Djibouti. Efforts to achieve a higher level of community confidence and trust in the revenue administrations would also bring benefits.

57. Stepping up efforts to fully digitalize revenue administration could yield additional tax revenue. Experience with the implementation of ASYCUDA World at Customs has shown that while streamlining processes and expediting goods clearance, digitalization also reduces burden on taxpayers and improves governance by reducing collusion between taxpayers and revenue officials,[37] thus enabling revenue mobilization.[38] Efforts to deploy ASYCUDA World at all entry points should continue in order to realize the full benefits of customs digitalization. Also, digitalizing tax administration would move the DGI from the current manual systems to a reliance on electronic systems (e-filing and e-payment) and automated detection of non-compliance to lift taxpayer compliance, which in turn will impact revenue collections. Accelerating the implementation of SIGTAS at DGI will strengthen the tax administration's capacity to improve taxpayer compliance and mobilize revenues.

58. Sizable gains could be derived from focusing efforts on taxpayers with high revenue potential. Focusing the DGI's limited resources on the largest 300 taxpayers is critical for managing compliance risks and achieving higher revenue intakes. DGI has demonstrated a good understanding of taxpayer segmentation by establishing dedicated units to administer the direct taxes (business profit tax and pay-as-you-earn) of the large and the medium size taxpayers. Experience has shown that, to be effective, these dedicated units should administer all core taxes and carry out all tax administration functions, including taxpayer services, return processing, audit (all types), and collection enforcement. Based on its experience with the management of the largest businesses' profit tax, DGI has announced the establishment of a full-fledged LTO.

[36] John Brondolo, Annette Chooi, Trevor Schloss and Anthony Siouclis, March 2022, Compliance Risk Management: Developing Compliance Improvement Plans, IMF Technical Notes and Manuals, Fiscal Affairs Department (Washington: International Monetary Fund).

[37] Revenue Mobilization for a Resilient and Inclusive Recovery in the Middle East and Central Asia; IMF 2022.

[38] https://unctad.org/system/files/official-document/dtlasycuda2022d1_en.pdf

59. Establishing a pilot full-fledged LTO could facilitate reform implementation. The LTO could be used as a pilot project for modernizing the DGI's organization, systems, and procedures. It could be an ideal means to introduce modern filing and payment procedures and better services. The DGI's efficiency and effectiveness will likely improve, providing a model to be subsequently extended to the management of other taxpayers. By focusing on a few taxpayers (200 to 300 largest taxpayers), the LTO will provide a controlled environment to benefit from the new systems and procedures before they are deployed to a much larger taxpayer base. For example, the deployment of SIGTAS could be piloted in the LTO. In addition, by providing a single point of contact, the LTO will be beneficial to large enterprises and foreign investors in terms of reducing their compliance costs.

60. Other specific customs administration reforms could include: (1) accelerating efforts to facilitate e-payments; (2) strengthening valuation control through the use of the ASYCUDA valuation module, (3) strengthening the management of exemptions, free zones, other suspensive regimes and disputes; (4) improving the management of excises (khat, hydrocarbons, cigarettes, alcohol, etc.); (5) introducing post-clearance control programs according to international standards; and (6) enhancing capacity to check customs declarations.

Developing Institutional Capacity[39]

61. DGI and DGD would benefit from developing their capacity to implement reforms and improve revenue mobilization. Strong institutional capacity and adequate resources are needed to implement the reforms. More autonomy, flexibility in resources allocation, modernization of the management of human resources, and enhancing skills and competencies of staff alongside the implementation of sound governance and accountability framework are likely to foster success.

[39] Benitez, Juan Carlos, Mansour, Mario, and others (2023). Building Tax Capacity in Developing Countries. Staff Discussion Note SDN/2023/006. International Monetary Fund, Washington, DC.

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