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## **Enhancing the Effectiveness of Fiscal Policy for Domestic Resource Mobilization: Issues Paper**

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## **I. Background**

1. African countries, with the support of their development partners, have taken several actions to boost economic growth, engender development, and enhance prospects for meeting the Millennium Development Goals (MDGs) by the 2015 target date. As a result of these measures, some progress, albeit modest, has been made in achieving a number of MDG targets. For example, the 2009 MDG report of the Economic Commission for Africa (ECA), the African Union Commission (AUC), and the African Development Bank (AfDB) indicates that progress has been made in enhancing labour productivity growth, increasing primary education enrollment and reducing gender inequality. Despite these positive developments, countries in the region are still not on track to meet the MDGs.

2. One of the factors militating against rapid progress in meeting the MDGs is the lack of adequate finance. Recent studies indicate that in most countries in the region, there is a wide gap between total investment needs and domestic resource mobilization. In other words, African countries face significant financing gaps. Sachs et al (2004) suggest that sub-Saharan Africa (SSA) would need an additional ODA per year of about \$US 25 billion to meet the MDGs. Similar estimates were obtained by the Blair Commission for Africa. There are also studies that indicate that the estimates are much larger. For example, the 2008 report of the MDG Africa Steering Group suggests that to achieve the MDGs, external public financing to Africa needs to increase to \$US 72 billion per year.

3. The varying estimates of the financing gap are indicative of the fact that proper assessment of the MDG financing needs of countries is fraught with difficulties. This is because it requires forecasts for future growth rates as well as assumptions about the elasticity of poverty with respect to per capita income. Given the uncertainties associated with the evolution of growth rates, forecast errors are likely to be large. It is therefore not surprising that existing estimates of the financing gap vary widely.

4. Foreign aid has an important role to play in closing the financing gap in the short run, especially given the historically low savings ratio of several countries in the region and the fact that they have limited access to international capital markets. Donors recognize this fact and have made promises to scale up aid flows to Africa. However, there is a wide divergence between aid pledges and actual disbursements and this is likely to increase as donors expend large sums of money to bail out domestic financial institutions and increase demand in response to the global financial crisis. This implies that, while aid flows have an important role to play in the short run, it is not wise policy to rely on such flows as the principal source of development finance. Consequently, African countries need to seek alternative sources of financing if they are to meet their investment needs and development goals.

5. History and econometric evidence have shown that domestic resource mobilization is an effective way to finance long-run sustained growth and development. There are several advantages associated with this source of development finance. First, it is less volatile and more stable than external finance. For example, recent evidence suggests that aid receipts in SSA are two times more volatile than tax revenue receipts (Hill, 2005). Second, domestic resource mobilization allows for country ownership of development policies and outcomes. One of the concerns that African policymakers have with the existing system of aid delivery and management is that it imposes conditions that constrain their ability to adopt policy paths consistent with national development priorities. This lack of policy space has severe negative consequences for the attainment of national development goals.

6. Third, domestic resource mobilization reduces reliance on external flows, hence the risk of the “Dutch disease”. In-flows of external capital often lead to an appreciation of the real exchange rate and a loss of international competitiveness, with dire consequences for exports. Furthermore, reliance on external finance increases vulnerability to speculative attacks on currencies as well as financial crisis (Osakwe and Schembri, 2002). Fourth, when governments derive a significant portion of their revenue from taxation, they are likely to be more accountable and use public resources more efficiently because taxation creates incentives for public participation in the political process. Fifth, trade reform is increasingly being adopted by African governments and in some countries it has been associated with an erosion of the fiscal base (Osakwe, 2007). Boosting domestic resource mobilization would reduce vulnerability to reductions in revenue arising from trade reforms.

7. Domestic resource mobilization has two important elements. The first is enhancing government revenue (public savings) and the second is increasing private savings. Consequently, governments as well as individuals and firms must be important actors in any effective resource mobilization process. While mobilizing domestic resources is desirable, the benefits are not automatic. They accrue to countries that take adequate steps to exploit them. Furthermore, resource mobilization is not a costless activity and its effectiveness depends on whether governments have the political will and the capacity to create a stable environment as well as put in place appropriate economic policy measures.

8. Fiscal policy plays a crucial role in domestic resource mobilization. For example, it can affect the capacity of governments to increase domestic revenue and create incentives for households and firms to save. In recognition of this fact, the 2009 ECA Conference of African Ministers of Finance, Planning and Economic Development, and the AU Conference of African Ministers of Economy and Finance is being organized under the broad theme “*Enhancing the effectiveness of fiscal policy for domestic resource mobilization.*” Against this background, this issues paper examines the nexus between fiscal policy and domestic resource mobilization. It is organized as follows: Section II presents an overview of development finance in Africa while section III examines the nature of fiscal policy in Africa as well as challenges posed by the global financial crisis. Section IV focuses on strengthening domestic revenue mobilization and section V discusses how to boost private savings. In section VI, we take up the question of how to direct ODA towards strengthening capacity to mobilize domestic resources.

## **II. Development finance in Africa: some facts**

9. The resources for development in Africa come from essentially four broad sources: domestic savings; foreign aid; private capital flows and remittances. As in the past, domestic savings remain the most important source of development finance to the region. Historically, the ratio of domestic savings to gross domestic product (GDP) in Africa is low compared with other developing-country regions. For example, over the period 1990-1994, the average savings ratio was 16.5 per cent for Africa compared with 37.4 per cent for East Asia and the Pacific and 20 per cent for South Asia as well as Latin America and the Caribbean. In recent years however, African countries have made modest progress in mobilizing domestic savings as evidenced by the fact that the average savings ratio for the region was 24 per cent for the period 2003-2007. A large part of this increase was due to rising commodity prices and in the current environment of declining global economic activity, it is unlikely to be sustained.

10. The low aggregate saving ratio in Africa, obscures the fact that there are wide differences in saving ratios across countries. Algeria, Angola, Botswana, Chad, the Congo Republic, Equatorial Guinea, Gabon and Nigeria, had savings ratios above 30 per cent of GDP over the period 2003-2007 while countries such as Burundi, the Comoros and Eritrea had a negative savings ratio. It is interesting to note that the high-saving countries are mostly oil or mineral exporting countries while those with negative saving rates are fragile States.

11. Another interesting feature of domestic resource mobilization in Africa is that the region's savings ratio is low relative to investment requirements. This represents a serious constraint to growth. Studies have shown that countries with high growth performance tend to have high saving ratios (Rodrik, 2000). Consequently, one of the key challenges of African governments is how to increase domestic savings and channel them into socially productive investments.

12. Private capital flows have emerged as a significant source of development finance in Africa. Net private capital flows to Africa increased from \$US 17 billion in 2002 to \$US 81 billion in 2007. Since 2005, the share of private capital flows in total external finance to Africa has been more than that of aid flows. A large part of private capital flows to the region is in the form of foreign direct investment (FDI) and these flows are concentrated mostly in oil and mineral exporting countries. Consequently, the benefits as well as employment impact in the region has been quite limited. Progress has also been made in attracting other forms of private capital flows. For example, Ghana successfully mobilized \$US 750 million through issuance of a Eurobond in 2007. Gabon also had a similar positive experience in accessing international capital markets. Several African countries (Kenya, Nigeria, etc.) had plans to raise funds through this source in 2008 and 2009. However, the tightening of credit and an increase in risk premiums in response to the global financial crisis has shattered these plans. It has also led to the drying up of private capital flows to developing countries with serious consequences for Africa.

13. With respect to official development assistance (ODA), three points are worth noting. First, there has been an increase in aid flows to Africa since the adoption of the Monterrey Consensus, reflecting largely efforts by the international community to help countries in the region increase prospects for meeting the MDGs. Aid flows to Africa increased from \$US 21 billion in 2002 to \$US 38.7 billion in 2007. Second, there has been a shift in the allocation of aid away from production activities into the social sectors with dire consequences for resource mobilization. For example, the share of aid disbursements to the production sectors in Africa declined sharply from 15 per cent in 2002 to around 8 per cent in 2006. In contrast, the share of social infrastructure and services rose from 60 per cent to 69 per cent over the same period. Third, there is growing interest in improving the quality of aid as an important element in enhancing aid effectiveness. While some progress has been made in improving aid quality since the Paris Declaration, policy conditions, aid fragmentation, and lack of aid predictability continue to pose severe challenges for recipients.

14. In recent years, workers' remittances have become an important source of development finance. Remittance in-flows to SSA increased from \$US 4.6 billion in 2000 to \$US 20 billion in 2008. These flows go to the private sector and so contribute to private savings. National and international actions are needed to reduce the transactions cost of remittances and maximize its contribution to growth and poverty reduction in Africa.

### **III. Understanding fiscal policies in Africa**

15. In modern economies, fiscal policy has short and long term functions. In the short to medium term, the key function is to stabilize an economy. This can be accomplished through using current expenditures to compensate for declines in private spending thereby cushioning the effects of shocks to demand. In the long term, however, the objective should be to increase an economy's productive capacity and this can be accomplished directly through an increase in public investments. It can also be done indirectly through stimulating private investments.

16. The ability to perform these functions in any given economy depends on domestic capacity to mobilize resources, and especially public revenue. It is the effective mobilization of domestic revenue that gives governments the latitude required to use fiscal policy in a manner consistent with national development priorities. An analysis of the revenue performance of Africa yields the following conclusions. First, since the 1990s, the ratio of revenue to GDP in Africa has been around 20-23 per cent, which is similar to ratios observed in other developing-country regions. A large part of the increase in revenue generation in Africa is, however, attributable to by oil exporting countries.

17. Second, the tax-GDP ratio for Africa has been between 18-19 per cent since the 1990s. This is also similar to ratios elsewhere. Therefore, at the regional level, Africa is not doing worse than other developing countries when it comes to revenue generation. The aggregate figures, however, mask important differences at the country level. Tax ratios in several countries are still below the 15 per cent threshold considered necessary for low income countries. Third, although several African countries continue to rely heavily on trade taxes, the share of trade taxes in total revenue is declining, particularly since the beginning of the new Millennium. In contrast, the share of indirect taxes in total revenue has gone up while that of direct taxes has been basically stagnant.

18. Turning to government expenditures, since the 1990s, the ratio of expenditure to GDP in Africa has been broadly in line with revenue ratios. However, at the country level, it seems that in many low-income countries revenue mobilization has not kept pace with rising public spending, especially in the aftermath of the fuel and energy crises which weakened their fiscal positions. This challenge has been compounded by the global financial crisis which is affecting fiscal positions of African countries through three main channels. The first is the decline in economic activity and the associated reduction in government revenue. Second, the bail-out of financial institutions and adoption of fiscal stimulus plans in advanced countries has led to fears of possible declines in ODA, which several countries in the region depend on for financing government expenditure. Third, governments are under pressure to increase social spending in order to protect vulnerable groups.

19. An interesting but worrying feature of fiscal policy in Africa is that it tends to be pro-cyclical (Thorton, 2008). That is, fiscal policy is expansionary during booms whilst downturns are associated with fiscal contractions (Ilzetzki and Vegh, 2008). There are several reasons why African countries tend to adopt pro-cyclical policies despite the presumed benefits of counter-cyclical policies. Lack of policy space due to conditions attached to lending by international financial institutions limits the set of policy choices available to countries in response to shocks. In addition, financing for low-income countries is generally pro-cyclical. In good times countries are able to borrow and in bad times they have very limited access to finance. This constrains the ability of low-income countries to run counter-cyclical fiscal policies.

20. The existence of fiscal rules aimed at ensuring long-term fiscal sustainability also makes it difficult for countries to use fiscal policy to off-set the impact of shocks to output. As part of efforts to enhance regional integration, some regional economic communities (RECs) introduced convergence criteria that effectively limit flexibility in the use of fiscal policy for stabilization purposes. There are also political-economy reasons why a government might adopt pro-cyclical fiscal policy. For example, it is generally difficult to moderate the growth of spending during booms because political pressures are often brought to bear and prove too strong for policymakers to resist.

21. Granted that African countries have not exploited the potential of fiscal policy as a counter-cyclical mechanism for cushioning the effects of shocks on macroeconomic variables, the natural question to ask is what could be done to change the situation? At the international level, pressure should be brought to bear on international financial institutions to eliminate policy conditions associated with lending. Such conditions impose enormous costs on recipient countries and there is growing evidence that they have not led to better outcomes. At the national level, governments need to resist the temptation to spend during commodity booms so that they will have more fiscal space during downturns. They should also be more cautious in adopting fiscal rules that constrain their ability to respond appropriately to cyclical fluctuations in economic activity.

#### **Issues for Discussion**

- What are the driving forces behind the evolution and dynamics of fiscal policy in Africa?
- How should fiscal policy respond to cyclical fluctuations in economic activities?
- How can fiscal policy be used more effectively in support of the development needs and priorities of African governments?
- How can African countries respond to the fiscal challenges posed by the global financial crisis?

#### **IV. Strengthening domestic revenue mobilization**

22. The public sector remains an important supplier of public goods in Africa. It also maintains law and order which is vital for long-run sustainable development. Governments can finance these activities through tax and non-tax revenue as well as borrowing. Consequently, enhancing domestic revenue mobilization is necessary to create fiscal space and increase the ability of governments to perform these functions effectively. Although Africa has essentially similar average revenue to GDP ratios as other developing-country regions, the revenue performance of several countries has been weak. For example, several countries have tax ratios below 15 per cent and there is a wide gap between tax capacity and actual tax revenues. Some of the factors responsible for this low performance include: low per capita income and growth; impact of trade reforms; institutional problems; and weak governance.

23. Sustained economic growth is a necessary condition for successful revenue mobilization. A growing economy has better potential to create formal sector employment and increase the pool of taxpayers. It also increases potential revenue from indirect taxes. But growth will generate more revenue if there is structural change, improved economic policies, and better tax administration. In most countries, agriculture accounts for a very large share of GDP and employment. Furthermore, a large part of the labour force employed in agriculture is in the

informal sector where taxation is difficult. Diversification of the production sector is needed to bring more people into the formal sector and increase the pool of tax payers. Such structural change will also reduce dependence on commodities which tends to increase volatility of government revenue with serious consequences for output and the provision of public goods.

24. Improved fiscal policies are needed to increase revenue mobilization. Governments often grant tax exemptions and incentives to foreign investors as part of investment promotion strategies. This shrinks the tax base and there is no convincing evidence that it enhances foreign investment in the region. There is also considerable scope for increasing revenue through reducing tax exemptions on corporations, increasing VAT rates on luxury consumption items, and making more efforts to boost revenue from property taxes and excise duties. Reliance on trade taxes in an environment characterized by increased global economic integration poses considerable difficulties for African countries. Reducing vulnerability from this source requires efforts to increase revenue from non-trade taxes through diversification of the tax structure. However, this takes time. Therefore, African countries should adopt a careful and gradual approach to trade liberalization to ensure that it does not erode the fiscal base.

25. Strengthening domestic revenue mobilization requires better tax and customs administration. Inefficiencies in fiscal administration reduce the capacity of governments to mobilize revenue, as well as encouraging tax evasion. There is growing consensus that sustained efforts to improve tax and customs administration will increase tax revenue without the need to raise rates on existing taxes. Computerization of tasks, improved tax audits and reporting, and training of tax officials are examples of important steps needed to address inefficiencies in fiscal administration. In this regard, there is the need for international assistance in building institutional capacity in the region.

26. Good governance is important for successful resource mobilization. Tax evasion and avoidance tend to be high in economies where there is weak governance. Households and firms are less likely to take their tax responsibilities seriously in economies with a high incidence of fraud or corruption. At the national level, there is the need to improve efficiency and accountability in the use of public resources. Linking tax collection to service delivery, better public financial management, and more transparency in resource use are necessary to accomplish this objective. Good governance is also needed at the international level. For example, OECD countries need to take measures to eradicate tax havens and should make it very difficult for public officials from developing countries to hide stolen assets in their financial institutions. Dealing with the governance problems at the national level without addressing these global governance issues will be counter-productive.

27. Successful mobilization of domestic revenue in Africa requires dealing with the external-debt problems of the region. High external debt results in future capital outflows and often creates debt-servicing difficulties with consequences for resource mobilization. External debt also affects resource mobilization by increasing vulnerability to shocks thereby contributing to macroeconomic instability which constrains growth. Because of these drawbacks, it is often suggested that African governments should finance activities through domestic rather than foreign borrowing. While domestic borrowing seems more appealing than foreign borrowing because it does not involve exchange rate risk, it also has limitations. When governments raise money through issuing bonds locally, it puts pressure on real interest rates and may reduce private sector credit with consequences for private investment. Domestic borrowing can create a medium to long term fiscal sustainability problem and this should be taken into account when



borrowing decisions are made. It should be recognized that the ability of African governments to raise money through this source is limited by the shallowness of domestic financial markets.

#### **Issues for Discussion**

- What are the channels through which fiscal policy affects mobilization of domestic revenue in Africa?
- How can African governments integrate into the multilateral trading system without eroding their domestic fiscal base?
- What should African countries do to increase efficiency in the use of domestic revenue?
- How can revenue from natural resources be used more effectively in support of development needs and priorities of resource-rich countries?
- How can foreign investment be promoted without jeopardizing domestic revenue mobilization objectives?

#### **V. Boosting private savings**

28. Governments do not have direct control over private savings. However, they can contribute to its mobilization indirectly through creating a good physical and social environment as well as adopting appropriate economic policies. In Africa, this role of governments is particularly important because one of the reasons why domestic savings ratios in the region are less than those in other developing country regions is the poor performance of African countries in the mobilization of private savings. Some of the factors constraining mobilization of private savings in the region include: low income; weak domestic financial infrastructure and systems; high dependency ratio; uncertainty associated with macroeconomic policies; capital flight; weak governance and political instability.

29. The ability of households and firms to save depends largely on their capacity to generate income which can be influenced by governments through the creation of an enabling environment for private sector development. One area where there is the need for public action is in reducing the high cost of doing business which hampers private investment and has a negative effect on income and savings. Public investment in infrastructure is one way in which fiscal policy actions could reduce transactions costs and create incentives for private investment and savings.

30. The development of the domestic financial sector is a necessary condition for enhancing private savings. But financial systems in Africa are underdeveloped and dominated by banks which focus on short-term lending and do not cater for the long-term financing needs of investors. These banks have not been effective in mobilizing savings because of factors such as weak infrastructure, information problems, and lack of confidence in banking institutions. Financing of deposit insurance schemes through fiscal policy actions could help instill more confidence in banks and increase deposits and savings.

31. Strengthening domestic financial institutions could also be achieved through market incentives that encourage financial institutions to mobilize savings and channel them into productive investments. For example, the development of markets for long-term government bonds and provision of public guarantees, for a given percentage of bank loans, could reduce risks faced by domestic banks and create an incentive for them to engage in long-term lending. African governments could also influence private savings through promotion of linkages between formal and informal financial institutions. The former have the resources but lack accurate

information on borrowers' risks. On the other hand, informal institutions have lower costs of operation as well as better information on borrowers' risks. Establishing linkages between formal and informal financial institutions will improve access by small-scale businesses to financial services. Governments should also rebuild public financial institutions such as development and agricultural banks in order to expand the basis for savings and provide long-term development finance.

32. Capital market development can contribute to the mobilization of savings in the region. However, African countries have not fully exploited this potential. The development of capital markets in the region is constrained by limited market size, weak financial market infrastructure, lack of equity capital, difficulties in obtaining information, absence of appropriate regulatory frameworks, weak governance and lack of investor confidence in stock exchanges. Microfinance institutions can also contribute to the mobilization of savings especially in the rural areas and the urban informal sector. In this regard, efforts are needed at the national level to strengthen the capacity of these institutions to play their role in resource mobilization.

33. Capital flight represents a serious obstacle to mobilization of resources in Africa. Although it is difficult to quantify the exact magnitude of capital flight, available evidence suggests that the region loses as much as 4 per cent of its GDP annually as a result of capital flight (Boyce and Ndikumana, 2000). Better governance and law enforcement, as well as economic policy reforms and political stability are required to reduce the incidence of capital flight.

#### **Issues for Discussion**

- What factors militate against effective mobilization of private savings in Africa?
- How can capital markets contribute more effectively to resource mobilization?
- What national and international policy actions are required to stem capital flight?
- How can African countries exploit the potential of microfinance for domestic resource mobilization?

#### **VI. Enhancing the role of aid in domestic resource mobilization**

34. The role of ODA in the economic development of recipient countries is a contentious issue that often evokes emotions in Africa as well as within donor communities. Aid skeptics argue that it perpetuates bad governments, enriches elites, and creates a disincentive for governments to boost domestic resource mobilization. On the other hand, proponents of aid are of the view that it complements domestic savings and supports growth and poverty reduction in recipient countries (Radelet, 2006).

35. Notwithstanding the controversy, there is an understanding that most countries in the region will remain reliant on ODA in the short run, especially in the current era of deteriorating global economic activity. There is also the understanding that domestic resource mobilization should be the basis for financing long-term sustained growth in the region. Consequently, the focus of the debate is slowly shifting to how aid can be used to increase capacity for domestic resource mobilization and lay a solid foundation for sustained growth. There are several reasons why aid has not played a significant role in resource mobilization in Africa. First, current aid allocation mechanisms rely on identifying a financing gap and then seeing how aid could close

this gap. This approach can undermine incentives for savings and tax collection, and needs to be re-examined.

36. Second, as a result of emphasis on the MDGs, there has been a shift in aid allocation from economic infrastructure and production to the social sectors. This dramatic shift has negative consequences for the development of productive capacity which is crucial for dynamic and sustained growth. By stimulating growth, governments create the necessary conditions for enhancing domestic revenue and private savings. In this regard, it is important that financing of social sectors is not achieved at the expense of financing of the economic infrastructure and production sectors. These sectors should not be in competition with each other because financing for economic infrastructure can make a positive contribution to growth and generate more revenue to finance social sectors.

37. Third, ODA flows to Africa often finance domestic consumption rather than investment which is an engine of growth and is necessary to generate revenue. Furthermore, a significant percentage of ODA to Africa finances capital outflows in the form of debt service payments and foreign-exchange reserve accumulation. Using panel data for SSA over the period 1965-2006, Serieux (2009) shows that 35 per cent of ODA financed capital outflows, 41 per cent financed domestic consumption, and only 24 per cent financed domestic investment. Reversing this trend is a critical element in ensuring that ODA supports national priorities of African countries.

38. Another way in which ODA could be directed to boosting capacity for domestic resource mobilization is to link aid allocation to actual revenue generation in recipient countries. For example, donors could reach an agreement with recipient countries that they will match a certain percentage of the funds generated by recipients subject to a fixed limit. The initial limit could be set based on agreements with recipients and it could be reduced as recipients increase capacity to mobilize domestic resources. This matching-funds approach will create an incentive for governments to take necessary actions to boost domestic revenue. It will also increase transparency and efficiency in the use of public resources.

#### **Issues for Discussion**

- What is the impact of aid on development financing in Africa?
- Should African countries have an explicit exit strategy from aid-dependence?
- How can ODA be directed towards boosting capacity for domestic resource mobilization in Africa?

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