

Domestic Resource Mobilization in Africa: An Overview

Bolstered by external aid, global demand for commodities and recent macroeconomic stability, growth in Sub-Saharan Africa has outpaced most of the world over the past decade. Sustaining this expansion will depend, however, on a shift toward greater reliance on domestic resources — that is, government revenues and domestic savings and investment — to fuel growth.

Enhancing domestic resource mobilization (DRM) in the region is not just necessary, but desirable. Greater reliance on internal resources increases a country's ownership of public policy, ties accountability to citizens instead of external investors and aid donors, and reduces the volatility associated with outside funding.

It is widely accepted that external sources like aid will be insufficient to meet the Millennium Development Goals and sustain progress beyond the 2015 target date. Moreover, the success stories of East Asia and more recently China and India show the value of a growth path underpinned by high levels of domestic savings and investment.

Increased DRM makes huge sense in the current global economic context. Donor countries' aid budgets are an easy target when, as now, austerity is a priority, and experience has shown that aid levels often do not return to pre-crisis levels. As well, many donor countries feel an increasing sense of aid fatigue.

The recent DRM push rests on a foundation now almost a decade old, with the Monterrey Consensus in 2002 making improved DRM the first of its six leading actions. The Monterrey goals were reinforced at the Doha conference on Financing for Development in 2008. Several recent initiatives underscore increasing interest, and even urgency. The UNCTAD report, *Economic Development in Africa 2007*, focused on DRM and Developmental States, while a United Nations University study looked at DRM and Financial Development (UNU-WIDER, 2008). The 2009 launch of the African Tax Administration Forum, the first such platform for exchange between tax authorities in Africa, has increased the focus on DRM. Finally, the African Economic Outlook in 2010, with its focus on Public Resource Mobilization and Aid, underscores DRM's promise for Africa.

Drawing on case-studies of five Sub-Saharan countries: Burundi, Cameroon, Ethiopia, Tanzania and Uganda; this brief identifies challenges to increasing DRM, but nonetheless finds strong potential.

Key Points

- Enhanced domestic resource mobilization (DRM) in Sub-Saharan Africa is critical for state-building and government accountability.
- There is significant untapped DRM potential in the region.
- Donors would see strong returns from shifting more resources into strengthening DRM.

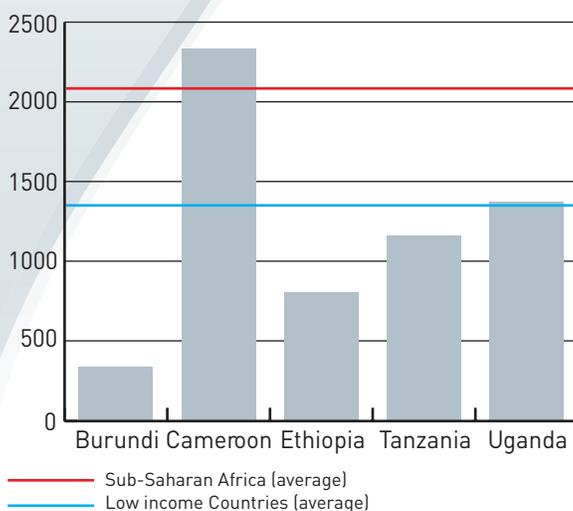


Tax mobilization remains weak, despite significant reforms. Capital flight, tax evasion and avoidance and proliferation of tax exemptions further erode the tax base.

Main findings: Public resource mobilization, which comprises tax, non-tax and other government revenues, is vital for state-building. Investment in public assets like infrastructure is necessary before private investment can take hold. Such efforts bear fruit only in the context of wider macroeconomic stability, towards which Sub-Saharan Africa has made significant progress in recent years.

While the general picture across the continent is of increasing tax mobilization, this has been driven almost entirely by increasing resource revenues in resource-rich countries. Other countries, including those in our project, have had a tougher time increasing their tax take, despite significant reforms in some cases. Collections typically fall far below their potential, and tax systems are not as responsive to growth or policy changes as in other developing regions.

Gross Domestic Product per capita, PPP (USD) 2008



Source: African Development Bank statistics department and World Development Indicators database

The project countries all share several **structural factors** that hamper public DRM. One is very low income. Per-capita GDP is far below even the Sub-Saharan average in all except Cameroon, and below the average for Low Income Countries in all except Cameroon and Uganda. As well, the vast majority of the population works in largely subsistence agriculture which accounts for 15 to 45% of GDP in the countries studied. Our empirical analysis shows that as agriculture rises as a share of GDP, tax mobilization falls. The growth of commercial and for-export niche farming in such countries as Ethiopia and Uganda has not helped revenue mobilization significantly: even where the sector contributed to overall growth (as in

Ethiopia) its contribution to taxes has declined. Another common structural factor with detrimental impact on DRM is a large informal sector.

Tax bases across much of Africa are very narrow. The tax burden falls disproportionately on the small formal sector of the economy. Burundi is an extreme example where just one company contributes nearly 20% of total collection.

The tax base is further eroded by high levels of **capital flight, evasion and avoidance**, with the result that even during growth upswings, tax collection can actually decline, as happened in Ethiopia. A key issue is the proliferation of **tax exemptions** applied on an ad-hoc and discretionary basis. The resulting foregone revenues were estimated across the study countries at a massive 5-10% of GDP, or from one-third to more than half of total revenues mobilized.

Tax authorities face serious **capacity constraints** and **lack legitimacy**. Corruption and negative perceptions of tax officials are major issues, especially in Burundi and Cameroon. The latter has one of the most onerous tax systems in Africa. The result is that even those who wish to comply find it difficult to do so. **Transparency**, which affects taxpayer morale, is also important. Citizens view paying taxes as worthwhile only if they see visible results from the ensuing public expenditure.

Private resource mobilization is in some ways even more important, as it is largely the financial system that acts as the conduit to channel savings into investment. Private DRM is hampered by many of the constraints noted above. Saving is a challenge when incomes are low, and rural and agriculture-dependent sections of the population often lack access to financial institutions. Moreover, the financial sector is highly fragmented across formal institutions like banks, semiformal ones like microfinance organizations, and informal arrangements.

The vast **majority of the population lacks direct access to the formal financial sector**. Only about 2% of Burundians, 5% of Cameroonians and 6% of Tanzanians have bank accounts. There is one bank branch per 125,000 people in Ethiopia, while Uganda – which has made progress in this area – has one deposit-taking institution for every 87,000.

Banks often impose **minimum deposit requirements and fees** that are higher than most incomes. Real interest rates in several of the project countries are negative, while lending rates exceed deposit rates by as much as 20% in some cases, reflecting high overheads, poor credit coverage and little competition in the

financial sector. The number of adults covered by either public or private credit bureaus across the study countries is a fraction of even the Sub-Saharan average. It is ironic, then, that the banking sector across Africa is one of the most profitable in the world. Part of the reason is that banks are flush with excess reserves which are invested in low-risk government securities, while the private sector lacks access to credit.

Underdeveloped capital markets and a complete lack of other long-term financing are major constraints to development. Stock markets exist, but, with only a handful of listed companies, trading is infrequent and market activity dogged by insider trading. Corporate bond markets are non-existent; even secondary markets such as in government securities and inter-bank lending are at a nascent stage. Development banks have been closed in recent years.

The result of all this is that most **savings are precautionary and held in non-financial forms** (such as livestock, commodities or construction equipment) that are hard to estimate and not readily available for investment. The duration of savings tends to be short. In the absence of a financial system that can meet their needs, people rely on informal networks and a growing microfinance sector. Except in Cameroon, the domestic savings rate in the project countries is lower than the average for Sub-Saharan Africa, which as a region has the lowest savings rate in the world, and far lower than what will be needed to sustain enough investment to meet the Millennium Development Goals.

Moving forward: Domestic stakeholders and the international community need to work together on a broad agenda to enhance DRM, which they must recognize as essential to securing Africa's future. While achieving this will be challenging, it is possible, desirable and necessary.

The starting point must be the tax system. Tax issues are thought of as mainly technical, but the real constraints are often political will and leadership. Policymakers must view **tax reform as part of wider reforms** to improve the business and investment climate. Reforms to both tax policy and administration must be consistent with an overall growth and development strategy. It should be stressed that these are long-term processes, and therefore entail setting reasonable expectations and targets.

There is considerable scope for **simplifying tax systems**. A necessary first step is a comprehensive review of the exemptions regime and investment codes, which could offer the added benefit of

broadening the tax base. In general, exemptions should be used sparingly and be time-bound. Another means of base broadening is implementing or better collecting **property taxes**. This provides an example of the importance of political will, as there is often strong resistance from wealthy and well-connected property-owners.

Our studies suggested several measures to **improve compliance**, including the computerization and modernization of tax systems and payments; the introduction of taxpayer ID cards; and using innovative approaches to bring more of the informal sector into the tax base through such incentives as offering basic business support and linking tax-returns to collateral and credit constraints. Measures to **strengthen taxpayer motivation** by increasing transparency and accountability include: taxpayer rights charters; timely publication of government receipts and expenses; engaging with domestic policy communities working on taxation and with local media; and working with institutions such as the judiciary and auditor general to ensure access to information and clear channels for addressing grievances. Governments need to lead by example by taking strong action against **proven cases of corruption** in tax authorities.

Considerable efforts are needed to **enhance private DRM**. As is the case with public DRM, a stable macroeconomic environment is a prerequisite for a well-functioning financial system. Across Africa, reforms have moved financial sectors towards greater liberalization, yet it remains uncertain whether this has mobilized more savings or resulted in more efficient investment. What is certain is that the formal financial system has shrunk in terms of coverage and more people now depend on informal and semiformal institutions. There is a need to **foster links** among all institutions – formal, semiformal and informal – within each country's highly fragmented financial sector.

Basic financial sector informational infrastructure such as credit bureaus and land registries tend to be highly underdeveloped in most countries. Building this infrastructure can have significant payoff, since it is essential for the development of housing and other long-term credit markets.

Governments need to **increase competition in the banking sector** by removing barriers to entry and exit. Minimum requirements and punitive banking charges need to be brought under control. **Pensions systems** could be broadened to cover more workers and, if opened up and linked to **development of capital markets**, could have a significant payoff.

The starting point must be the tax system. Tax issues are thought of as mainly technical, but the real constraints are often political will and leadership.

Domestic Resource Mobilization in Africa: An Overview

The international community can do much more to support DRM in Africa by increasing assistance aimed at enhancing tax capacity, ensuring greater coherence across aid, trade and investment policies, and limiting multinationals from lobbying for tax exemptions in poor countries.

Further development of capital markets, especially inter-bank money markets and secondary debt markets, is critical for DRM. Development finance institutions and development banks have a checkered track record across Africa. The failure, however, lies not in the concept, but in management and political interference. **A new approach** to these institutions is needed, because, in the absence of other forms of long-term financing, they play an essential role in deepening and developing capital markets.

Roads, electricity and other basic public infrastructure are prerequisites for banks to move into rural and unbanked areas. While new technologies such as mobile phones are already helping to overcome geographical and cost constraints in those areas, they could be further leveraged to link the formal financial system to semiformal institutions.

The **international community and donors** can play a major role in helping countries enhance DRM in Africa. While donors have been involved in building tax capacity and supporting the financial sector for some time, recent estimates show that **less than 2%** of technical assistance to Africa goes towards building tax capacity. Yet the payoff for such support is high, as proven by successful experiences in countries like Rwanda and Ghana.

Donors can help build tax capacity by providing computer and other IT hardware and software, as well as support the development of management capacity. Similar efforts to help develop financial sector infrastructure, such as underwriting the costs of setting up credit bureaus and registries, would also go a long way.

The international community, recognizing the importance of DRM, must ensure **greater coherence across their aid, trade and investment policies**. In particular, expectations of trade liberalization must be moderated as tariffs and duties, while declining, still account for an important share of Africa's revenue mix. Donors can also lead by example. In most countries,

donors rarely pay taxes or duties on goods and services they import. This reinforces the culture of exemptions and favoritism. Voluntarily **paying taxes** on donor-funded goods could have an important signaling effect.

The international community can also support DRM by ensuring their mining companies **do not lobby for tax exemptions**, and pay their fair share of taxes. Corporate lobbying for exemptions needs to be reviewed to ensure the tax base is not eroded in the name of investment promotion.

Finally, aggressive measures are needed to stem **illicit capital flight**, which is twice as great as aid flows to the region. Reversing even part of this perverse upstream flow would significantly help DRM. ☹

This is a summary of "Do it yourself" Development: A Synthesis Report on Domestic Resource Mobilization in Africa" by Roy Culpeper and Aniket Bhushan and "Enhancing DRM for Effective Development: Role of the Donor Community" by Aniket Bhushan and Yiagadeesen Samy.

To read the full papers, go to www.nsi-ins.ca and follow the research links.



The North-South Institute
L'Institut Nord-Sud

The North-South Institute
55 Murray Street, Suite 500
Ottawa, Ontario Canada
K1N 5M3

Telephone: (613) 241-3535
Fax: (613) 241-7435
Email: nsi@nsi-ins.ca
Website: www.nsi-ins.ca

The North-South Institute acknowledges the generous financial support of the African Development Bank (AfDB), the Canadian International Development Agency (CIDA), Canada's International Development Research Centre (IDRC) and UKaid from the Department for International Development (DFID).



Canadian International
Development Agency

Agence canadienne de
développement international

Canada

