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"Do-It-Yourself" Development: A Synthesis Report on Domestic Resource Mobilization in Sub-Saharan Africa#

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Context

There have always been schools of thought in the development literature skeptical about the usefulness of aid. Right-wing critics[1] argued that aid stifles markets and leads to excessive government. Left-wing critics argued that heavily aid-dependent countries often have no choice but to accept the self-serving policies imposed on them by donors.

In parallel to the debate on the usefulness and impact of aid was another debate on the impact of other external links between developing and industrial countries, notably through trade and foreign investment. The debate was stimulated in the 1950s and 1960s by Prebisch[2] who claimed that trade based on comparative advantage would "immiserize" the developing countries, and Singer[3] who also questioned the benefits of foreign investment. Comparative advantage, according to their argument, would induce developing countries to specialize in commodity exports and industrial countries in manufactured exports. Over time, deterioration in the terms of trade would mean that industrial countries would reap most of the benefits of trade while developing countries would forego the benefits of industrialization and fall increasingly behind the developed countries. The Singer-Prebisch hypothesis implied that developing countries should pursue a strategy of restricting trade and encouraging import-substituting industrialization. However, mainstream thinking and development policy (articulated, for example, by Little, Scitovsky and Scott in 1970), went in the opposite direction, by arguing that openness to external economic relationships was beneficial, and encouraging developing countries to embrace trade liberalization and encourage foreign investment.

During the last decades of the 20th century, growing frustration with poor results from foreign aid programs led to the Millennium Development Goals (MDG) campaign launched in the year 2000. Time-bound development targets were set for the combined efforts of developing countries and their partners in the donor community. Subsequently, principles of aid effectiveness were articulated in the "Paris Declaration" of 2005. Some donor countries also committed to significant increases in their ODA by 2015, the target year for the MDGs.

Notwithstanding these attempts to make aid more focused and effective, it is not surprising that recently some observers have questioned the renewed emphasis in the MDG campaign on foreign aid.

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[1] P.T. Bauer, *Dissent on Development.* Cambridge, Mass.: Harvard University Press, 1972.

[2] Raul Prebisch, "The Economic Development of Latin America and its Principal Problems," reprinted in *Economic Bulletin for Latin America*, Vol. 7, No. 1, 1962, 1-22.

[3] Hans Singer, "The Distribution of Gains between Investing and Borrowing Countries," *American Economic Review*, **40**, 473-485.

Critics from vastly different perspectives argued for securing an early exit to aid (Moyo[4] and Tandon[5]) or for radically reduced expectations from foreign aid (Easterly[6]).

In the eight years after the launch of the MDG campaign, much of the developing world, including Africa, experienced an economic boom unparalleled for the previous three decades, and exceeding growth levels in the industrial countries. This unexpectedly positive turn of events seemed to reinforce arguments suggesting that Africa could "go it alone", that is, contemplate an early "aid sunset."

But then the global financial crisis erupted in the United States and Europe in 2008-9, spreading deep recession around the world, and setting back the gains in economic growth made in Africa during the previous years. Consequently, aid budgets were cut, and trade with and capital flows to developing countries slowed down significantly. The setback also reinforced arguments that African countries should be less dependent on aid, more self-reliant, and less vulnerable to the vicissitudes of economic swings in the industrial countries.

The Monterrey Conference and DRM

In March 2002, the United Nations convened a conference in Monterrey, Mexico, on Financing for Development. The objective was to recommend ways forward among various avenues of financing development. Six sets of "leading actions" were called for in the Monterrey Consensus that emerged: mobilizing foreign direct investment and other private flows; capitalizing on international trade as an engine of development; increasing international financial and technical cooperation (i.e. foreign aid); sustainable debt financing and external debt relief; and enhancing the coherence and consistency of the international monetary, financial and trading systems ("systemic reform"). However, the *first* leading action invoked by the Monterrey Consensus was "Mobilizing domestic financial resources for development"—the subject of this report.

Less than two years earlier, the U.N. had convened its Millennium Summit. Its Declaration resulted in the Millennium Development Goals, a series of time-bound targets (including the halving of poverty and

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[4] Dambisa Moyo, *Dead Aid: why aid is not working and how there is another way for Africa.* London: Allen Lane, 2009.

[5] Yash Tandon, *Ending Aid Dependence.* Cape Town, Dakar, Nairobi and Oxford: Fahamu Books and Geneva: The South Centre, 2008.

[6] W. Easterly, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good*. New York: Penguin Press, 2006.

hunger) with a deadline of 2015. The Monterrey Consensus aimed at ensuring that the necessary resources to deliver the MDGs were identified and then mobilized.

The five years following the Monterrey Conference were a period of optimism, based on the economic boom in the developed countries that followed a decade of expansion, with a short pause for the "dot-com" crash in 2000. This led heads of government at the 2005 G8 Summit at Gleaneagles to call for the doubling of foreign aid by 2010. Some G8 donors went much further, announcing dates before 2015 by which they would reach the 0.7 percent ODA/GNI target. At the same time, the boom years led to dramatic increases in investment flows to, and exports from, the developing countries. Moreover, many of the outstanding debt problems of developing countries had been addressed via initiatives aimed at the Heavily Indebted Poor Countries (HIPC) and through Multilateral Debt Relief.

Likely because of expanding aid, trade and private capital flows, there was less progress on the other two leading actions invoked by the Monterrey Consensus: notably systemic reform, the sixth, and domestic resource mobilization, the first. Systemic reform was at least a subject of ongoing international debate, even if there was little progress. In comparison there was very little attention being paid to domestic resource mobilization.

Accordingly in 2007, The North-South Institute assembled a team of researchers from five countries—Burundi, Cameroon, Ethiopia, Mozambique[7], and Tanzania—to do some preliminary thinking about the challenges to and opportunities for domestic resource mobilization in these five countries. In partnership with the African Development Bank and the African Economic Research Consortium, the Institute organized an inception workshop in May 2008. A background paper was presented[8], along with some contextual material from each of the five case study countries. In the ensuing months, the project team prepared detailed proposals for each case study.

However, as the proposals were being finalized and the studies launched, the global financial crisis gained momentum, precipitating the worst economic downturn since the Great Depression almost 80 years earlier. The issue of enhancing domestic resource mobilization suddenly gained a prominence it had lacked ever since the Monterrey Conference. African experts such as Aryeetey (2008) argued that

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[7] Because of a departure in the research team member from Mozambique in 2008, it was necessary to substitute Uganda as the fifth country case study. The five countries were chosen in consultation with CIDA, one of the project's supporters.

[8] Roy Culpeper and Aniket Bhushan, "Domestic Resource Mobilization: A Neglected Factor in Development Strategy".

"the use of domestic resources for development purposes is becoming more and more important as access to foreign resources becomes increasingly difficult."[9]

The global crisis also convinced policy-makers in Africa that the time had come to reduce their region's dependence on external resources and their vulnerability to external financial shocks by addressing the potential of domestic resource mobilization. Commissioners, senior tax administrators and policy-makers from 39 countries met at an extraordinary conference in Pretoria in August 2008. They discussed the importance of taxation in state-building, and the changing environment of taxation in Africa. They advocated creating the African Tax Administration Forum to lay a strong basis for a new approach to taxation, state-building and capacity development of African tax administrations[10]. ATAF was formally launched in Kampala in November 2009.

The African Development Bank has also indicated its concern for enhancing domestic resource mobilization, the subject of its annual flagship report, the *African Economic Outlook.*

African countries were not alone in recognizing the urgency of enhancing domestic resource mobilization (DRM) in a global climate of economic uncertainty and contraction. The OECD made the issue of enhancing DRM through taxation the focus of its annual Global Forum on Development in January 2010[11].

These developments suggest that the issue of DRM is finally receiving the attention that it deserves. The North-South Institute's project thus provides a timely contribution to the policy debate, and makes a number of recommendations for African countries and their partners in the donor community to advance the agenda.

Why Mobilize Domestic Resources?

Developing countries that have achieved and sustained high rates of growth have typically done so largely through the mobilization of their domestic resources. Domestic resource mobilization (DRM) at a significant level is also essential to solidify ownership over development strategy, and to strengthen the bonds of accountability between governments and their citizens. In effect, DRM provides "policy space"

[9] Ernest Aryeetey (2008), "The Global Financial Crisis and Domestic Resource Mobilization in Africa."
[10] International Conference on Taxation, State-building and Capacity Development in Africa, Pretoria communiqué.
[11] OECD (2010), "Taxation in Africa: the Path to Economic Independence." Position Paper. (May).

to developing countries which is often constrained under the terms and conditions of external resource providers.

Foreign aid comes with conditionality or policy strings, attached, not to mention procurement restrictions that accompany "tied aid". Moreover, aid also tends to be pro-cyclical and volatile.[12] Foreign direct investment typically flows into sectors and projects dictated by the commercial interests of the foreign investors—for example, natural resource extraction. Moreover, governments heavily dependent on foreign aid or on sharing the profits of foreign investors have less incentive to raise taxes and less reason to pay attention to the demands of taxpaying citizens.

Both the public and private sectors must be involved in strategies to enhance DRM. Governments mobilize domestic resources primarily through taxation and other forms of revenue mobilization. The private sector mobilizes resources by channeling the savings of households and firms through banks and other financial institutions which then provide credit or investment capital to households and small and medium enterprises. Public sector revenue mobilization is crucial to strengthen the capacity of the state to deliver public goods and services such as transportation infrastructure, health and education. Private sector DRM is crucial to create employment, incomes and sustainable livelihoods.

It is in Sub-Saharan Africa that some of the steepest challenges to DRM are encountered: savings rates are low, dependence on foreign aid is high and chronic, and institutional capacity to mobilize domestic resources is weak. Sub-Saharan Africa has clearly lagged other developing regions, notably those in Asia, in its savings performance, although it has kept abreast with Latin America and the Caribbean (Table 1):-

[12] Aid is found to be four times as volatile as domestic resources, and aid volatility is greater in more aid dependent countries.

Table 1

Gross Domestic Savings

(Percent of GDP)

Country Group	2004	2005	2006	2007	2008	2009	2010
Developing Asia (1)	38.4	41.4	44.0	44.9	43.8	43.5	45.3
Sub-Saharan Africa (2)	18.3	19.2	24.8	22.6	23.3	20.3	21.6
Western Hemisphere (3)	21.9	22.0	23.2	22.5	22.8	19.2	19.9

Source: IMF, *World Economic Outlook,* April 2010

1. Composed of 26 countries: Republic of Afghanistan, Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, India, Indonesia, Kiribati, Lao People's Democratic Republic, Malaysia, Maldives, Myanmar, Nepal, Pakistan, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Democratic Republic of Timor-Leste, Tonga, Vanuatu, and Vietnam.
2. Composed of 44 countries: Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Republic of Congo, Côte d'Ivoire, Equatorial Guinea, Eritrea, Ethiopia, Gabon, The Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, São Tomé and Príncipe, Senegal, Seychelles, Sierra Leone, South Africa, Swaziland, Tanzania, Togo, Uganda, Zambia, and Zimbabwe.
3. Composed of 32 countries: Antigua and Barbuda, Argentina, The Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, Uruguay, and Venezuela.

The North-South Institute's Project on Domestic Resource Mobilization

In the second half of 2007, The North-South Institute began planning its research project on domestic resource mobilization as a policy response to chronic aid dependence in developing countries. But it was also conceived as a means of limiting developing countries' vulnerability to *other* forms of dependence on external resources and shocks. For example, excessive borrowing has often led to debt crises. Foreign direct investment is often focused on natural resource extraction, leading (for example) to the "oil curse". Export earnings can be extremely volatile. And, as Prebisch and Singer maintained, dependence on commodity exports has often been subject to deteriorating terms of trade.

In planning its research, enhanced domestic resource mobilization was not conceived by the Institute as a *substitute* for such external resources, which can play (or should be *encouraged* to play) a

development-friendly role (e.g. via debt that is sustainable; foreign direct investment whose benefits are widely shared helping to reduce poverty; aid conditionality that is not intrusive or socially destabilizing; and diversified exports to smooth out volatile earnings). Accordingly, continued recourse to aid, foreign trade and investment was envisaged as necessary complements to domestic resources, albeit on a lower scale. Moreover, in addition to reducing vulnerability to various kinds of external shocks, domestic resource mobilization is also seen as a vital building block of development in its own right.

Domestic financial resources are mobilized by both the public sector and the private sector. For the most part, public resource mobilization takes the form of taxation or similar kinds of revenue generation by governments or public authorities. Such revenues are vital to providing public services—roads, health, education, security and defence, etc. In short, adequate taxation is fundamental to enabling states to govern their citizens.

In the private sector, on the other hand, banks and other financial intermediaries mobilize savings from households and enterprises and lend to borrowers who invest in productive activities, creating jobs and incomes.

In the era of foreign aid, many of the services normally delivered by the state—health and education, for example—have been substantially financed by donors, particularly in the poorest, most aid-dependent countries. This may be justified in the short-term as a way of kick-starting a self-sustaining process of development: health and educated children will become more productive adults, leading to sustained economic growth, leading to increased revenue generation for the state. (The MDG campaign was rationalized in precisely this way.) However, there is a danger that chronic aid dependence may make states "lazy"—less inclined to tax their citizens, as long as donors are prepared to foot most of their bills. In the longer term, a viable state must be able to mobilize the resources it needs to deliver the services citizens require.

Similarly, the process of financial intermediation cannot be left primarily to private foreign investors, who primarily invest in sectors and projects in their own commercial interest. There may be spillovers to the local economy via employment or taxation (unless these are negotiated away through exemptions or incentives). But such spillovers do not take the place of financial institutions that mobilize savings for investment by local farmers, and small and medium sized enterprises, to meet local needs and sustain local livelihoods.

Four questions were posed to help define the conceptual framework of analysis:

- Do countries with greater DRM grow faster or perform better economically?
- How can greater DRM contribute toward reducing aid dependence and increasing policy space/ownership?
- What are the key policy and institutional drivers of greater DRM?
- What role can aid donors play in facilitating greater DRM?

Country summaries

The North-South Institute examined possibilities for enhanced DRM in Sub-Saharan Africa through the lens of five countries: Burundi, Cameroon, Ethiopia, Tanzania and Uganda. Together these five cases represent a breadth of circumstances in SSA – Burundi being a post-conflict country, Cameroon experiencing declining oil revenues, Ethiopia transitioning from a planned to market-based economy, Tanzania and Uganda both with longer reform records and where resources revenues (mineral and oil) are expected to play an increasingly important role.

These five countries were examined to assess the constraints to and opportunities for mobilizing resources through taxation and through the private sector, including both shorter- and longer-term possibilities. A summary of key conclusions by country follows. First, a brief overview of the countries surveyed is in order (Table 2).

Table 2

Key Indicators

	Population (million)	Gross savings/GDP	GDP/capita (PPP)	Net Aid/GNI
BURUNDI	8.074	4.1%	$ 380	43.9%
CAMEROON	19.088	20.3%	$ 2,170	2.3%
ETHIOPIA	80.713	17.4%	$ 870	13.0%
TANZANIA	42.483	13.2%	$ 1,260	11.7%

UGANDA	31.656	12.4%	$	1,140	11.8%

Source: World Bank, World Development Indicators, 2005-8 (most recent year)

Although all countries in the group are poor, some (Burundi and Ethiopia) are clearly much poorer. Gross savings ratios are all relatively low compared to regional averages in Sub-Saharan Africa (see Table 1) except perhaps in the case of Cameroon. Aid dependency ratios are all above 10 percent (Net aid/GDP ration) except in the case of Cameroon.

Cameroon is clearly an outlier in terms of its relatively higher income and lower aid dependence, but each country in the group is unique. Cameroon is also an oil exporter, but its petroleum reserves are depleting. Burundi is a post-conflict state, which is yet to emerge from its fragility with robust institutions, in comparison with its neighbour Rwanda, which shares a similar history of ethnic strife and civil war. Although its population is smaller than others in the group Burundi has one of the highest population densities on the African continent. Uganda also has a history of ethnic strife and violence, but since 1986 has enjoyed relative political stability under a democratic regime. Ethiopia, the third most populous country in Africa, remains one of the most heavily dependent on agriculture. Tanzania has avoided the civil strife and political upheavals experience by many other countries in Africa, and has implemented one of the most thorough programs of economic reform in the region.

Ethiopia, Tanzania, and Uganda have experienced rates of economic growth far above those of the last three decades. Cameroon has enjoyed a reprieve from its dwindling oil reserves in the form of a spike in oil prices in the run-up to the financial crisis of 2008-9. Burundi is perhaps the worst performer in terms of economic growth in the group.

A summary of key constraints and opportunities, by country, follows.

1. Burundi

Burundi is one of the poorest countries in sub-Saharan Africa. It is a particularly fragile state—a post-conflict society, having endured two decades of violent civil strife that resulted in hundreds of thousands of deaths. Burundi's governance remains weak, growth and development are anemic, and the country remains heavily dependent on foreign aid to survive.

In such an environment, enhancing domestic resource mobilization is extremely challenging. Yet there are realistic options that deserve serious consideration both by the Burundian authorities, by civil society, and by Burundi's aid partners.

In a country like Burundi, where private savings are negative and financial and other markets are extremely thin, the public sector has to lead national efforts to enhance DRM. It is quite feasible for Burundi to increase its tax yield and other public revenues without increasing the tax burden. The principal strategy for achieving this objective is a reform of the tax and customs administration and of the associated laws and rules governing the collection of revenues. Burundi's tax and customs administration suffers from inefficiency, incompetence and corruption.

Administrative reforms must include upgrading of skills and equipment, and of laws and tax codes. Numerous tax exemptions and loopholes, high marginal tax rates, lack of independence from the political authorities, and poor incentives to officials all serve to reduce tax revenues and feed corruption. It would be possible to reduce tax rates, and broaden coverage, and increase tax revenues. Simplified tax rules would reduce the scope for discretion and corruption. Also increased autonomy and independence from the Government is imperative—revenue officials must be hired on merit, not through political connections, and tax files must be managed by the Revenue Office without Government interference.

Burundi has initiated sweeping administrative reforms across all Government agencies including the Revenue Office, so the potential exists for improvements in the efficiency and integrity of its tax administration. Donors could help by monitoring the implementation of the reforms in the area of tax and customs administration. In particular, donors can insist that recruitment of management and staff must be based on merit and not through political interference.

While in the short- to medium-term the greatest potential lies in enhancing tax and customs revenues, there are also opportunities in the longer term for mobilizing resources through the formal and semi-formal financial sectors. In the formal financial sector there is a clear opportunity to augment the current system of pension and accident insurance, which currently provides coverage to some public and some private sector employees. An Office of Pensions and Occupational Hazards was set up in January 2010 for the benefit of civil servants. This should be extended to the private sector for the wider population. Some firms and unions have established schemes to supplement state pensions which are quite low. The Government could encourage retirement savings through these schemes by introducing tax incentives.

The other opportunity in the formal private sector is through increasing competition. Lack of competition in the banking sector has led to high lending spreads and weak incentives to lend to the private sector. Lowering the barriers to entry would help to increase competition. Moreover, demands for collateral are so high that many potential borrowing clients go unserved. This constraint could be relaxed somewhat by establishing a credit reference bureau to ascertain potential borrowers' creditworthiness. Donors could help in setting up information systems to make such a bureau viable.

In the semi-formal financial sector there has been rapid expansion of micro-finance institutions—some MFIs have experience annual growth rates of 40 percent. This sector helps to fill an important gap—providing financial services to low-income people. However, rapid expansion without adequate supervision has led to instances of mismanagement and fraud. The government, with the support of donors and international MFIs, should provide technical assistance (skills training and assistance) and support to improve the supervisory framework so that this sector can provide dependable support (including deposit-taking facilities) to low-income families.

2. Cameroon

Cameroon is a lower middle-income country—of the sample of five countries it is the most advanced as measured by GDP/capita and other indicators. Nonetheless, a large portion of the economy (50 percent of output and 90 per cent of employment) is in the informal, non-taxed sector.

Thus an obvious opportunity exists to expand tax revenues by broadening the tax base to include the informal sector. Many small firms are able to pay tax but simply do not by staying out of the purview of the state. The process of bringing these firms out of the informal sector involves registration, which is complex, tedious and time-consuming (requiring 12 procedures compared to

an average of 5.5 in OECD countries). Thus a benefit of streamlining the registration of firms is to put them on the tax rolls.

Another opportunity to broaden the tax base is in the area of real estate and property income. A 0.1 percent tax on registered properties and 5.0 percent tax rental incomes exists, but very few properties are registered and the tax is virtually uncollected. As in the case of widening the tax base to include the informal sector, a massive effort is required in registering properties (and can possibly go in tandem with business registration). Property-owners could be encouraged or obliged to register their properties over the next five to ten years. Incentives could be provided to property-owners through urban infrastructure (water, roads, electricity). Meanwhile in the short term, existing legislation should be implemented to collect tax on registered properties. Ancestral lands in the countryside could be exempted to avoid popular discontent.

Public revenues are deeply eroded by corruption in the Tax and Customs Administration. Fighting corruption has been on Cameroon's reform agenda since 1988, but results so far nave been negligible. Successfully fighting corruption through the following measures could significantly boost tax revenue. First, by systematically sanctioning guilty officials and taxpayers alike (through wide publication of court decisions). Second, regular rotation of tax officials could break networks created with taxpayers to defraud the state. Third, re-enforcing border controls to check illicit goods and import of counterfeit goods could also have a positive impact on tax revenue. Fourth, creating facilities for online declaration and eventual payment of taxes could substantially improve tax administration and curb collusion between tax authorities and taxpayers to defraud the state.

There is also a huge opportunity to enhance resource mobilization through financial markets in the private sector. Despite Cameroon's status as a lower middle-income country, about 95% of Cameroonians do not use banking services as penetration of financial institutions (including microfinance institutions) is very limited, especially in rural areas. A number of institutional constraints, for example the limited use of non-cash payment instruments and poor infrastructure (roads, electricity and telecommunication) especially in the rural areas are to blame.

The government in collaboration with the private sector should strive to expand access to financial services which could enhance DRM and increase financial intermediation. The following policy changes would be helpful. First, the government should revoke the need for authorization to open/close branches of financial institutions, requiring such institutions merely to inform the financial authorities of their decision to extend their outreach. Second, the government/central bank could work with financial institutions to reduce the cost of opening bank accounts and the

minimum balance requirement. Third, financial institutions could also be assisted to implement non-cash payment instruments which are still largely underutilized and introduce mobile phone banking in collaboration with mobile telecom providers as is the case in a number of African countries. Fourth, improving rural infrastructure (electricity, telecommunications, and roads) could facilitate the extension of financial services (and especially the semi-formal) to rural areas not presently served with banking facilities. Fifth, an acceleration of the process of creating credit bureaus to provide financial institutions with reliable credit and financial information on the creditworthiness of potential borrowers should have a positive impact on financial intermediation. A liberalized financial system with limited credit/financial information will not promote financial intermediation.

In Cameroon, about 99% of bank credits are short and medium term. Such a credit structure reflects the structure of bank deposits which are 75% short and medium term and are not supposed to finance long term credits according to prudential requirements. The Douala Stock exchange, established to mobilize long term savings, has failed and all the development finance institutions created to provide long-term finance for investment were all liquidated during the financial sector reforms, due to mismanagement. There is therefore need to create appropriate savings mobilization instruments and institutions in Cameroon.

The following financial sector reforms could work to improve savings mobilization. First, create a bond market to raise non-tax revenue from the public, rather than relying on advances from the central bank with risk of crowding out private sector initiatives. Second, set up a development bank with appropriate management structures devoid of political meddling, and with windows that handle lending to agriculture, SMEs, and long-term investment projects. Private sector participation can be encouraged, but corporate interest should not be allowed to dominate its developmental goals. Potential funding instruments could be long-term bonds and pension funds.

There is also need to dialogue with fellow CEMAC members[13] to merge the Douala Stock Exchange with the sub-regional stock exchange in Libreville and locate the new institution in Cameroon with the largest potential market. A sub-regional stock exchange should guarantee greater transparency and less likelihood for insider dealing, and create the possibility of attracting more firms than a national stock exchange within the context of a monetary union. This might entail forgoing some CEMAC institutions and responsibilities to other members.

[13] CEMAC (Communauté Economique et Monétaire de l'Afrique Centrale) is a regional economic and monetary association of six Central African states—Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon.

3. <u>Ethiopia</u>

Ethiopia is a relatively large country, predominantly agrarian, landlocked, and very poor. Eighty percent of the population is employed in agriculture. Domestic resources are relatively untapped by both the public and private sectors.

With respect to public resource mobilization, the principal reason is low tax effort. Despite historically unprecedented growth since 1992, particularly in the business community, corporate tax revenue has remained weak, due to both widespread tax exemptions and widespread evasion. Taxation of the largest sector, agriculture, has also remained marginal. The sector has also enjoyed growth, which should have contributed to greater tax generation.

Another source of tax evasion has been the large volume of illegal trade, particularly in the eastern part of the country. Remedying this issue is problematic in that a large number of people derive their livelihood from illegal trade, so that curbing the trade would necessitate moving these people to alternate livelihoods.

There are a number of policy options to address Ethiopia's weak tax performance. Most fundamentally there is a need for significant capacity-building in tax administration. A recent initiative to identify taxpayers is commendable, but capacity to maintain the taxpayer database is needed in order to keep the system up to date. Furthermore, the tax administration needs to develop a tax assessment capacity for the entire country. A related issue is to examine the level of taxes and duties and their impact on evasion. It is possible such an examination might reveal that lowering the level of taxation and duties might reduce the incentive to evade although the net effect on tax revenue cannot be predetermined. Finally, there needs to be an effort to increase the level of compliance. Capacity-building would require an upgrading of skills of revenue officials as well as the equipment and hardware available to the tax administration. Some of these measures can be introduced in the short term, while others must be considered long-term possibilities.

Turning to mobilization of resources through the financial sector, it is evident that finance—both the banking and non-banking sectors—are still at an embryonic stage in Ethiopia. Despite recent growth in the sector, Ethiopia's banks have limited outreach, and are constrained by traditional banking services and a conservative credit-management system.

But despite the conservative credit-management policy, non-performing loans are unacceptably high. Moreover, banks operate with excess liquidity and reserves, which reduce their incentive to mobilize savings more aggressively. The majority of the population lives in rural Ethiopia with very limited access to financial institutions or services. Recently micro-financing institutions have helped to meet the needs of this population, but much more needs to be done. There is a need for institutional innovation to mobilize saving from small farmers and the urban poor. The financial sector has to develop saving instruments which are effective to reach the poor farmer but with low transaction costs.

With regard to non-bank institutions and mechanisms, there is potential in the medium to longer term to develop a capital market in Ethiopia, beginning with a market for government bonds. However, such market development requires financial, human, regulatory and related resources. In parallel, the rudimentary pension fund system could be deepened and widened beyond the civil service, to include the private sector and non-government organizations. A capital market would provide more diversified investment options for the funds beyond the narrow investments currently available.

Finally, the Ethiopian diaspora can play an important role in deepening the financial sector. Recently the central bank has allowed the opening of foreign exchange accounts, which can facilitate remittances to Ethiopia, and increase domestic savings and investment from these funds.

4. Tanzania

Like Ethiopia, Tanzania is a large, poor, predominantly agrarian country that has recently benefited from significant growth. This increases the possibilities of enhanced domestic resource mobilization both through taxation and through mobilizing domestic savings through the financial sector.

With respect to enhancing taxation revenues, as in the case of Cameroon, there is a potential to raise revenues significantly through property taxation. Although the Tanzania Revenue Authority is mandated by legislation to collect taxes on both residential and commercial properties in towns and cities throughout the country, the collection effort is very low. A possible reason is that the cost of collection is high—particularly updating information on properties and their owners. For their part property-owners' compliance can be enhanced through better provision of local services (road maintenance, garbage collection etc.). Finally, compliance can be increased by ensuring that tax assessment is affordable and that the differentiation of tax rates among properties of various sizes, in different locations (etc.) remains reasonable.

Currently a few large taxpayers (10 percent of all taxpayers, some 370 in 2006) contribute about 70 percent of total domestic revenues. Meanwhile about 71 percent of taxpayers, largely in the informal economy, contribute 10 percent of total taxes. Currently tax rates are too high and too narrowly based on a few taxpayers. This induces tax evasion. Lowering tax rates and broadening the tax base to include the majority of Tanzanians would have the effect of increasing tax revenues.

Another way of enhancing tax revenues significantly is through accessing the informal sector. One suggestion would be to induce micro- and small-scale enterprises (MSEs) to formalize, by assessing a simple and fair tax (e.g. a single presumptive tax) on such MSEs. Such a tax could be assessed on the basis of a few indicators: turnover, number of employees, floor space, etc.

As to mobilization of domestic savings through the financial sector, Tanzania's commercial banks have excess liquidity, and yet are failing to reach a considerable portion of the country. Current incentives neither encourage the banks to mobilize more savings, nor to lend to potential borrowers. Spreads between deposit and lending rates are critically high (over 13 percentage points), which makes borrowing very expensive and thus reduces the level of investment.

The interest rate spread could be reduced by increasing the deposit rate and reducing the lending rate, which would have the effect of simultaneously increasing savings and investment. The government should also work with the commercial banks to increase their activities in rural areas and to increase their lending to employment-intensive sectors.

In short, financial intermediation is working significantly below par in Tanzania. There is potential to deepen intermediation and elevate the contribution made by mobilizing domestic savings for domestic investment and growth. In the longer term there is also potential for developing the capital market in Tanzania, but this requires education of investors as to the benefits of participation.

A strategy of deepening the financial sector, expanding credit and developing the capital market is likely to have inflationary consequences. Thus policies of enhancing domestic resource mobilization should be coordinated with monetary and fiscal policy to contain inflation if it increases to a significant level.

5. Uganda

Uganda is a poor, landlocked country that has enjoyed impressive growth rates during the period 2000-2008. Like its neighbours, the performance of savings and domestic resource mobilization has lagged. This is true both in terms of tax generation as well as mobilization of savings through the financial sector.

Despite a number of reforms aimed at increasing tax revenues, these have stagnated at 13 percent of GDP. The principal constraint is the narrowness of the tax base; thus the principal means of increasing revenues is by widening the tax base. There are a number of possibilities which, if implemented together, could increase tax revenues by 3 percent of GDP (almost 25 percent).

First, the informal sector is significantly under-taxed. For example, with respect to sales taxes, the VAT is collected largely from imports, manufacturers and wholesale dealers; VAT is not applied widely in the retail sector, most of which is informal. By registering all informal traders for VAT on the commodities they deal in, tax revenues would increase significantly.

Second, there should be a review of tax incentives to assess the costs (in terms of revenues foregone) and benefits (typically, investment that would not have taken place), and to restrict the number of investment incentives given if the benefit/cost ratio is not significant. Once incentives are given, they are politically difficult to remove.

Third, with a view to including the informal sector in the business tax base, the National Identity Card should be implemented. This would help identify small businesses as well as keep better track of larger businesses. The next step would be to undertake a survey and an analysis to establish the potential tax revenue from smaller enterprises. There already exists a presumptive tax, which would address smaller enterprises that do not keep financial records. This tax is only weakly implemented, so it has the potential for widening the tax base and increasing revenues.

In addition there is scope for introducing new tax instruments in Uganda. In particular, a tax on residential and commercial properties should be introduced. Such a tax would be highly progressive and would help to finance local government expenditures.

Donors could play a useful role in providing technical assistance in designing such new tax instruments and sharing best practices among a number of countries.

With regard to the financial sector, the most glaring shortcoming in Uganda, recognized in the National Development Plan for 2010-15, is the unavailability of long-term financing for development. Some of the possibilities of resolving this problem warranting consideration include the following.

First, to increase the availability of development finance in priority sectors, the Uganda Development Bank should be recapitalized. Donors can provide technical assistance to help ensure systems and procedures are in place for proper its proper functioning. Donors could also provide lines of credit than can be used for lending purposes.

Second, alternative sources of long term capital should be encouraged. A prime candidate is the pension sector. The National Social Security Fund is the largest pension fund for the private sector. This organization, once its governance problems are addressed, could play a larger role.

Third, commercial banks should be encouraged to provide mortgage financing, which is highly limited at present. If the mortgage market were deepened, this would encourage savings and help diversify the products offered by the banks and the collateralization of their loans.

Donors could also provide technical assistance and capacity-building to help Uganda develop the long-term financing capabilities of its pension funds and banks.

Recommendations for developing countries

While it is clear that the mix of constraints to and opportunities for domestic resource mobilization differs between countries, a number of common themes emerge from this 5-country survey. Developing countries should consider policy initiatives in both the areas of greater tax mobilization and enhanced intermediation of savings for investment.

Tax mobilization. With regard to resource mobilization through governments, a multipronged tax reform strategy is imperative. The following measures, aimed at *strengthening the administrative and legislative framework of taxation,* should be considered as reform possibilities for the short- to medium-term:

1. *Enhance the integrity of tax administration*. Corruption is endemic and deeply rooted; dealing adequately with corruption is fundamental to reform efforts. In addition to enhancing the integrity of tax officials, greater independence of all responsible officials in tax administrations from political meddling is needed.
2. *Simplify tax laws and codes*. In many countries, the complexity of the legal framework provides leeway to taxpayers to evade paying tax and opportunities for corruption to tax collectors and taxpayers. Moreover, complexity makes tax compliance difficult even for those willing to pay taxes. Accordingly, a drastic overhaul and simplification of tax legislation and regulations is required.
3. *Build tax administration capacity*. Greater efficiency requires skills training and capacity building of Revenue Authorities through investment in hardware and software.

In the medium- to long-term, the following policies, aimed at *transforming the tax structure,* warrant serious consideration:

4. *Tax structure: close exemptions and loopholes.* The proliferation of tax loopholes and exemptions, which gravely undermine revenue generation, also provide a window for political interference in the tax system. Policy remedies include closing exemptions and loopholes if they cannot be justified as serving the public interest. Some exemptions require the cooperation of donors in heavily aid-dependent countries.
5. *Tax structure: better sequencing and greater coherence.* Trade liberalization has proved to be a particular challenge for many countries where tariff reduction has resulted in a significant loss in revenues, without being offset by increased revenues from other forms of taxation (e.g. VAT), or even by increased trade volumes. Trade liberalization and tariff reduction should be phased and sequenced to ensure that the impact of revenues is positive.
6. *Tax structure: lower tax levels and widen the base.* The tax base in all countries is currently very narrow: it is focused on a relatively few taxpayers (typically, wealthier individuals or larger,

more profitable enterprises) and tax rates are typically set very high. Such high rates stimulate evasion, in addition to the negative economic impact on productivity, investment etc. The policy remedy, aimed at enhancing overall tax generation, requires both a widening of the tax base and a lowering of tax rates to encourage compliance.

7. *Bring the informal sector into the tax net.* Many potential taxpayers, particularly micro- and smaller enterprises, are in the informal sector and outside the tax net. Most of the poor subsist in the "informal sector". However, there are many enterprises and individuals who are not poor, for whom informality represents a way of evading taxes and other social responsibilities. Including these requires more than simply a greater tax effort. Business registration or identification systems, which must be regularly updated, would be an important first step, but the process of registration must be greatly streamlined with fewer administrative obstacles, and achieved within much shorter time-periods. Improving financial and tax literacy would also help.
8. *Introduce (or implement) property taxes.* The potential of property tax—on both residential and commercial properties—emerged as a common theme. Where such taxes exist in theory, they are not levied in practice. Registration of such properties is fundamental if property tax is to become more of a reality.
9. *Ensure public expenditures have demonstrable results and social benefits.* The efficacy of tax generation cannot be divorced from the perceptions of taxpayers about governments' expenditures. Tax compliance is likely to rise if taxpayers observe benefits in terms of improved public services or infrastructure, for example, in better roads, water or sanitation services.

Intermediating savings for investment. With regard to enhanced mobilization through the financial sector, most of the policy measures recommended are more feasible in the medium- to long-term. The recommendations pertain to the formal, semiformal, and the public sector, and to the development of financial sector infrastructure.

With regard to the *formal sector* (primarily commercial banks), it suffers from two major shortcomings. It services relatively few clients, including government, even in a lower middle-income country such as Cameroon, where 95 percent of the population has no access to banking services, and is virtually non-existent in rural areas. Second, it is unable to provide longer-term credit, that is, financing for development purposes. The paradox is that commercial banks typically have excess liquidity, which both reduces their incentive to attract deposits, and also demonstrates their unwillingness or inability to provide more credit.

1. *Greater outreach to depositors by commercial banks is needed.* This will require a number of policy changes. For example, minimum deposit requirements are typically beyond the reach of most Africans; these need to be reduced or abolished. The establishment of branches often requires an arduous process and should be streamlined. In some countries, more competition may help in encouraging banks to provide services to depositors and borrowers, and reduce the often prohibitive lending rates.
2. *Greater outreach to borrowers is also needed.* A common theme among many countries relating to the constraints on lending capacity of banks is the paucity of information on potential borrowers. The *establishment and maintenance of credit reference bureaus* would be an essential step in establishing the creditworthiness of borrowers. This will require capacity building among banks and financial authorities.

3. *Widen the scope for pension funds.* Among other formal, non-bank financial sector intermediaries, pension funds represent a potential vehicle for enhanced savings mobilization and domestic investment. Currently eligibility for pensions is highly restricted. If more workers in the public and private sectors were provided access to pensions, this would both increase social security (albeit for relatively better-off workers) and also augment savings for long-term investment. Pension funds need investment outlets, and would also aid the development of local capital (i.e. bond) markets (see below).

With regard to the semi-formal sector (primarily microfinance institutions):

4. *Build capacity in and enhance the oversight of MFIs.* Non-bank semi-formal financial institutions, particularly microfinance institutions, play a growing role in providing financial services, particularly to the poor. However these often need technical assistance. In some cases they are subject to fraud as well as poor management. Proper supervision from national financial regulators is important.

There is also an important role for the public sector in providing savings for long-term investment and deepen capital markets:

5. *(Re-)establish development banks.* Given the paucity of long-term financing for development, and the inability of the private sector to provide such financing, there is a role for publicly-owned development finance institutions or "development banks". A primary aim would be to invest in small- and medium enterprises, and create long-term employment. Such institutions have had a patchy record in many sub-Saharan African countries, with instances of corruption, inefficiency, and non-performing loans. Accordingly, many were closed down during the reforms of the last two decades. However, in other parts of the developing world (Asia and Latin America) they have played a vital role, and they can do so in Africa, provided they are run on the basis of sound lending principles, and learn from the mistakes of the past. Development banks would be funded primarily by the state but could obtain funding from donors and capital markets (see below).
6. *Develop local capital markets.* In the long term, there is scope for the development of capital markets—particularly local bond markets. Stock markets are nascent—few shares are listed, trading volume is thin, and subject to insider manipulation. Most Sub-Saharan African countries are likely too small to support a viable stock exchange. In order to make stock markets more dynamic, regional cooperation among neighbouring countries is worth pursuing, in order to increase listings and trading activity.

Recommendations for donors

Although the primary responsibility lies with developing countries themselves, donors can expedite the efforts of sub-Saharan African countries to enhance domestic resource mobilization in a number of ways. With respect to **building capacity for public resource mobilization**:-

1. First and foremost, donors need to see their own role as more than simply channels for aid delivery. Donors and aid priorities are part of a wider set of issues that affect the relationship between the international community and SSA countries. This means *more coherence across trade, investment and development cooperation objectives and policies*. A more rational approach to trade liberalization and tariff reduction in SSA countries that rely greatly on trade taxes is an obvious starting point. Expectations regarding low income countries' ability to replace revenues lost to tariff reduction have in many cases been overly optimistic. Therefore donors could start by ensuring their trade and investment policies create a climate in which DRM can be enhanced.
2. An area where donors could lead by example is *ending tax exemption on aid funded goods and services*. In many SSA countries imports of aid funded goods and services play a major role. Donors rarely pay taxes on imported cars, other goods and rental properties, or contribute to local taxes, and yet in some cases donor presence creates sub-economies which represent a large sphere of commercial activity. This creates preferential treatment and exacerbates a 'culture of exemptions' and creates opportunities for corruption. Removing such exemption and complying voluntarily could have an important signaling effect to domestic elites and tax authorities.
3. The international tax cooperation agenda is intimately linked to development. This is an area where Africa's interests align with those of the wider international community. *Greater tax information exchange and cooperation agreements* could be a starting point in strengthening tax capacity (surveillance, administration and policy making) in SSA. Increasing transparency and deepening the quality of information exchange across tax jurisdictions is a priority, especially in light of the global financial crisis. Africa's huge losses to capital flight predate the current crisis. Reversing even a small percentage of this perverse flow could have a substantial impact on DRM in the region. Coalescing interests around international tax cooperation and development is an obvious starting point.
4. *Aid aimed at stimulating public resource mobilization* can have up to a ten-fold effect on DRM in African countries. And yet, technical cooperation to 'public sector financial management' in the SSA region is only about 2 percent of total technical cooperation (AEO, 2010). For instance, donors could help enhance the capacity of domestic policy communities working on taxation. This would have a further effect of making technical cooperation more demand-driven and thus more in line with country priorities. Taxpayer education is vital in creating informed bargaining and negotiation around tax issues and central to democratic governance. Ultimately such multipronged capacity building will enable SSA countries to forge a meaningful tax-payer social contract. The goal of such efforts must be to forge a virtuous link between enhanced mobilization and more accountable expenditure. At the country level there are past successes which lend credence to renewing donor support for broad-based tax capacity building. The UK's efforts in Rwanda and German efforts in Ghana are good examples. In each case a high degree of local ownership was an important success factor.
5. As noted above, most SSA countries rely on a narrow base of taxes. In some cases (such as resource rich countries) a handful of taxes dominate the fiscal mix. Enhancing DRM in most countries implies looking for new types of taxes and diversifying the revenue base. However systematic application of and revenue generation from new taxes is predicated on the existence of basic taxpayer infrastructure. Donors can play a valuable role in this regard. Property taxes are a good example. Presently property taxes represent the greatest revenue potential across several SSA countries. One of the common findings across countries is the lack of capacity and

lack of resources at the sub-regional and municipal levels. One way to get around this could be mobilizing property taxes and bringing them under the remit of municipalities. To effectively exploit the potential of property taxes *concerted efforts aimed at building land registries and carrying out local censuses are prerequisites. Donors could sponsor such efforts* as part of their support for DRM.

Donors can also play a major role in **building the infrastructure of the financial sector**. The following are possibilities warranting serious consideration for donor support:-

1. A case in point is credit reference bureaus. One of the primary reasons cited by most banks (public, private and foreign) in SSA for their inability to extend credit to individuals, entrepreneurs, and small and micro enterprises is the lack of credit histories and formal documentation. *Building credit reference bureaus and creating creditor databases* is partly an infrastructure issue and one that requires upfront investment (in IT, management and training as well as financial literacy). Donors could help initiate, or at least underwrite, these outlays to get the process going.
2. *Land and property registration*, as described above, is also a prerequisite *for the development of a coherent housing finance system and mortgage markets*. As in developed and emerging economies, housing finance is one of the main sources of long-term financing. Therefore investing in infrastructure linked to land and property registration could have a dual payoff if, in the long run, it is able to stimulate the development of homegrown mortgage markets. Deep and long-term oriented domestic capital markets are ultimately a crucial component of self-sustained DRM.
3. In a similar vein donors could assist in *appropriate design and development of pension systems, and where appropriate pension reform*. It is widely believed across the region that pension systems are a major untapped source of long-term financing due to numerous investment restrictions, and in some cases outdated laws that govern their activities. However, as this has proved a controversial area in other regions (like L. America) donors must work very closely with local stakeholders.
4. Many donor countries, and some developing countries (e.g. India and China), administer programs or institutional mechanisms aimed at fostering investment in small and medium enterprises, including publicly funded investment banks. Such donors and developing countries could provide *technical assistance to ensure that development banks are operated in an efficient, transparent manner.*
5. Several SSA countries are now significantly benefitting from resource rents. *Donors can play a constructive role in helping SSA countries better harness and manage their resource revenue potential*. First, they could start by pressuring their own mining companies to make fair deals with African counterparts with appropriate provisions for reviewing royalty and revenue sharing mechanisms if commodity prices move suddenly (either to the upside or downside). Second, donor countries can mandate their mining companies report revenues in a detailed and country-by-country basis. This would increase transparency and would further be consistent with international tax cooperation and information exchange efforts. Natural resource extraction has a huge social, environmental and human impact. It is incumbent on donors that they take strong steps to support African civil society, academic and other policy communities working on resource related issues. Donors could also build geological capacity often lacking in SSA resource

ministries, and often the reason resource potential is not appropriately harnessed. Finally, donors could assist SSA countries in the development of appropriate financial structures, such as stabilization funds and escrow accounts, in order to facilitate a more development friendly and equitable outcome of Africa's vast resource wealth.

6. The presence of a large and growing informal and semiformal sector in most SSA countries is both a serious challenge and a vital opportunity for enhanced DRM. The vast majority of productive economic activity in SSA countries takes place informally, which in many countries represents the most dynamic part of the economy. Over the years a diverse array of strategies, such as presumptive and turnover taxation, have been tried to tap the informal sector. A new approach could be to target the sector not with the aim of increasing revenue mobilization but learning more about informal economy dynamics and in the long run facilitating a transition to the formal economy. A good place to start would be to *introduce a basic form of small business and micro enterprise registration*. Here again, donors could play a vital role in underwriting some of the costs and supporting necessary infrastructure.

A Brief Conclusion

There are a number of payoffs to enhanced domestic resource mobilization in Sub-Saharan African countries—increased ownership and convergence with domestic development priorities; less vulnerability to external shocks; and a number of benefits associated with better governance. In the wake of the global economic crisis of 2008-9, African countries, and increasingly donor countries, are coming to the realization that enhanced DRM is both desirable and feasible. The initiative and responsibility rest largely with the developing countries. The constraints and opportunities differ among individual countries, so the optimum policy mix should take such specificities into account at the country level. Additionally, donor countries (and some other developing countries) can undertake a number of supporting measures through more coherent aid, trade and investment policies, and through technical assistance for Sub-Saharan African partner countries.

While enhanced DRM should serve to reduce vulnerabilities to external shocks because of aid, trade, and financial volatility, the aim should not be to secure an early "aid exit" and much less to eliminate trade and foreign investment inflows. (However, it may facilitate a more rapid reduction of aid dependence than would otherwise be the case.) Rather, a well-crafted DRM strategy should serve to complement and strengthen the development contribution of external resources to meet a much broader spectrum of domestic needs, thereby facilitating the effectiveness of development efforts by developing countries and their external partners.