DOMESTIC RESOURCE MOBILIZATION:
A Neglected Factor in Development Strategy

Background Paper

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Executive Summary

This paper was prepared as a background document for a research project exploring the potential of greater domestic resource mobilization (DRM) in sub-Saharan Africa. It argues that DRM deserves greater emphasis in development strategies aimed at sustainable growth and poverty reduction.

An explicit focus on domestic resource mobilization is relatively new in the development discourse, although it has antecedents in the extensive literature on savings, investment and growth. In the 2002 Monterrey Conference on Financing for Development, DRM came into prominence as the first of six “leading actions” called for in the Consensus declaration.

DRM refers to the savings and investments generated by households, domestic firms, and governments. In contrast to mobilizing external resources (through FDI, aid, trade, and debt relief), DRM offers the advantages of greater domestic policy ownership and greater coherence with domestic needs. It does not suffer from the disadvantages associated with FDI and foreign aid, which are tied to the objectives of foreign investors and donors. But it also presents obvious challenges in poor countries, to which attracting external resources may seem like an easier option.

We suggest that a greater emphasis on DRM can help developing countries to enhance their growth and economic performance, contribute toward increasing their policy space and ownership of development strategies, and reduce aid dependence. Although ultimately the private sector plays the more significant role in the process of mobilizing and investing domestic resources, the key policy and institutional drivers are in the hands of governments, particularly in low-income countries. In that context, public resource mobilization through taxation occupies a central role in building states and shaping their ties and accountability to society. Aid donors can play a supportive role through technical assistance but they must first explicitly recognize enhanced DRM as an objective requiring greater emphasis.

The paper sets out a framework to consider whether and how DRM may be enhanced in sub-Saharan Africa through: mobilizing savings and targeted investments, including in the informal sector and through microfinance; financial sector deepening and institutional development; changes in macroeconomic policy; measures to constrain and repatriate flight capital; legal and regulatory reform and the informational climate; the mobilization of remittances and Diaspora resources; and the mobilization and utilization of resource rents.

The paper is structured as follows. Section I (Introduction) lays out the argument for focusing on DRM. Section II proposes a definition of DRM (for the purposes of the project) and raises four questions that help develop a conceptual framework for analyzing DRM. Section III is a literature survey that focuses on situating DRM in the international policy dialogue. Section IV lays out a broader framework of inquiry within which our project plays a small part. Section V concludes and outlines the suggested research direction (including preliminary research questions and testable hypotheses). In addition to this background paper, a companion piece (shorter ‘discussion draft’) has been prepared that further refines the research agenda

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I. Introduction: Why focus on domestic resource mobilization?•

The purpose of this background paper is to provide a rationale and framework for a research project focusing greater policy attention on domestic resource mobilization (DRM) in developing countries. It provides the conceptual backdrop to a series of five country studies (all in Sub-Saharan Africa) that will explore the potential for greater DRM in those countries, along with the relevant policy recommendations.

Resources for development can be mobilized from domestic or external sources. For most countries, the bulk of resources for development are mobilized domestically rather than externally. The external sources can be grouped under four headings used in the Monterrey Consensus on Financing for Development: (1) foreign direct investment and other forms of private foreign investment; (2) export earnings from international trade; (3) foreign aid and technical cooperation; and (4) the proceeds of debts forgiven by international creditors. Domestic resources, on the other hand, stem from households, firms, and governments. Households generate savings; firms generate profits and net earnings; and governments generate taxes and other public revenues.

However, it is argued here that the crucial difference between domestic and external resource mobilization rests not only on the origin, but also on the *application,* of the resources in question. In other words, there are typically significant differences between the motivations for, and impact of (for example) FDI resources compared to domestic resources. FDI responds to the commercial profit opportunities of, and retained earnings flow to, foreign investors, while foreign aid and debt relief are often motivated by political objectives of the donors and creditors. These may or may not coincide with domestic development objectives. Or to put it the other way around, it would be difficult, indeed impossible, to meet domestic development objectives principally through mobilizing external resources. Not only would the quantity of external resources fall considerably short of the total needs of most countries, but they would also not "fit" the needs of many sectors. For example, most low-income countries are agrarian; yet the resource needs of agriculture and the rural population are seldom high priorities for FDI or even aid agencies.

The working hypotheses for the project are that higher levels of DRM (1) can facilitate higher levels of investment and economic growth and more rapid poverty reduction; and (2) can contribute toward reducing aid dependence (and/or dependence on FDI) and thereby increase domestic policy space and ownership. If available evidence supports these hypotheses, the project will identify the key policy and institutional drivers of greater DRM and associated actions to be considered by developing countries. Finally, the project will identify ways in which the donor community can facilitate greater DRM in partner countries.

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By way of some introductory observations, it is widely acknowledged that economic and social development entails a number of inter-related processes of transformation. These processes are complex and take many decades, even generations, to work themselves out. Over time, the standard of living and the quality of life improve, but typically not evenly throughout the population.

It is now commonplace to emphasize economic growth and poverty reduction as being at the heart of development—although these only capture a part of the transformational processes involved. Moreover, each of these also embodies complexities both on a conceptual and analytical level. For example, it is now accepted that poverty reduction not only entails reducing income poverty, but also increasing access to education and health services, and should be embedded in a framework of rights. In addition, formidable issues of causality and the dynamics of development confront all those trying to understand the determinants of growth and poverty reduction (Easterly, 2001).

Also commonplace in the development discourse over the past decade is the critical importance of "domestic ownership" to successful development outcomes (including higher growth rates that appreciably reduce poverty levels). The principal reasons are the failure of much externally-imposed policy conditionality during the 1980s and 1990s, the need for broadly-based political and social support for the policies adopted by developing country governments, and the tremendous diversity of opportunities and constraints facing different countries. These factors speak to the need for policies that are effective within specific historical and geographic contexts, and accordingly they suggest that economic and social policies may vary significantly among developing countries, even while they share the same development objectives (Rodrik 2007).

The rationale of a greater focus on DRM thus springs from the quest for sustainable growth and poverty reduction, and the need to create "policy space" to accommodate genuine domestic ownership and country diversity. In other words, it is hypothesized that greater DRM can facilitate higher levels of economic growth and poverty reduction, and can also be a powerful means of enhancing policy space and domestic ownership. Although these hypotheses need to be tested at the regional level and country level (in a series of five country studies), where they may generate region- and country-specific policy recommendations, this paper will adduce some theoretical and historical evidence to support the general arguments.

There is also a political economy rationale for advocating greater DRM. This relates to issues of governance and accountability. Countries, and in particular governments, that are heavily dependent on external resources, may become more beholden to suppliers of those resources than accountable to their own citizens. Budgets that are largely financed by oil (or natural resource) revenues or by aid donors may reflect oil companies' or donors' priorities rather than the needs of the population. This can be true even with democratically elected governments. There is evidence to suggest that higher levels of aid dependence erode the quality of governance, as measured by indexes of bureaucratic quality, corruption, and the rule of law (Knack, 2001).

Such political economy arguments provide additional cogent reasons for suspecting that greater emphasis on DRM is warranted on a number of grounds. Moreover, there is some overlap between these arguments and issues of domestic ownership and policy space, as noted above. However, the emphasis of this paper (and the project) is oriented toward the more purely economic rationale of development effectiveness, i.e. in achieving higher rates of growth and development objectives that are more attuned to each country's opportunities and circumstances.

By a greater emphasis on DRM it is not implied that external resources for development ought to be spurned, much less that autarky is the ultimate objective. Rather, it is suggested that there are a number of disadvantages associated with external resources that are not shared by domestic resources and are often overlooked or downplayed in the policy discourse. For example, aid receipts, export earnings and FDI inflows all exhibit considerable volatility and uncertainty. Aid is often associated with intrusive conditionality and sometimes with other negative economic impacts, such as Dutch disease (currency appreciation and reduced export earnings). FDI primarily serves the needs of investors (e.g. natural resource extraction) rather than the development priorities of the recipient country (e.g. employment- and income-creating investment in agriculture and manufacturing). Accordingly the presumption of this paper is that most low income countries should be expected to continue to mobilize both domestic and external resources, but shift the mix toward DRM.

The challenge confronting enhanced DRM, particularly in low income countries, is the obvious fact that domestic resources are scarce where poverty is deep and widespread. Accordingly, increasing DRM has been described as a "hard option" when compared to mobilizing resources through ODA and FDI (Aryeetey, 2004). However, such a position does not take into account the drawbacks and tradeoffs associated with external resources. Moreover, many low income countries are experiencing an *erosion* of domestic resources due to other policies. For example, tariff reduction (due to policies of trade liberalization), reduced revenues from corporate taxation (due to incentives to promote FDI), and capital flight (which can be facilitated by capital account liberalization) should be questioned because they undercut DRM sometimes very seriously (on tariff reduction see Baunsgaard and Keen, 2005). Similarly, if macroeconomic policy is heavily oriented toward price stabilization and inflation targeting, it may lead to high real interest rates which constrain borrowing, investment and growth.

The rest of the paper is organized as follows. The next section addresses conceptual issues related to DRM. The third section provides an overview of the DRM literature, situates the same in the international policy dialogue and contextualizes DRM in Africa. The fourth section presents a framework of inquiry. A short concluding section will pose a series of questions that need to be tested further at the regional and country level.

II. Conceptual Issues

<u>Proposed definition of "domestic resources" and "enhanced DRM" for the purposes of this research project</u>

A 'domestic resource' could be anything and everything from domestic financial capital, to 'human capital', to 'social capital' to 'natural resources'. Heuristically this is not helpful.

For the purposes of this research project **we propose to define 'domestic resources' as "fiscal and financial resources accruing within the domestic economy".** This includes private-corporate and household savings; corporate profits and retained earnings; and public sector revenue.

The **rationale for this definition is that focusing on fiscal and (both formal and informal sector) financial resources, to a large extent captures the activity, changes and transformations taking place in other domestic resources (noted above)**. Furthermore, **this definition lends precision to what we mean by 'enhanced DRM'**.

By 'enhanced DRM' we mean one or more of the following:

1. **Increased (public, private-corporate and household) savings mobilization**
2. **Increased and improved (i.e. more efficient) intermediation (savings into investment), and greater allocative efficiency of investment**
3. **Increased and improved public sector (non-debt domestic) revenue mobilization and improved allocative efficiency of public investment and recurrent expenditures**

In this section we outline a conceptual framework within which to analyze DRM. A good place to start would be a definition of DRM. As noted in the introductory section and literature survey, DRM is intuitively regarded as resources originating from domestic agents, notably households (via savings), businesses (via retained earnings) and government (or the public sector, via taxation and revenue generation). Some of these resources are often re-invested: household savings in household enterprises (e.g. the family farm) and retained earnings are ploughed back into firms; while governments invest in physical or social infrastructure. Through financial sector intermediation, households, businesses and government are able to invest in third parties, for example banks attract household savings (and commercial deposits) and provide loans to firms and households for investment. However, in extremely poor countries much of the population may not be able to access banks or the financial sector[1].

Four questions are 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?

[1] In situations of deep and widespread poverty, which prevails in much of sub-Saharan Africa and other parts of the developing world, much of the household population subsists in the non-monetized economy, and is therefore beyond the reach of banks and financial intermediaries. Although available evidence confirms that such households are known to generate savings, it is primarily for precautionary purposes, while investment takes the form of acquisition of livestock, farm implements or education for children.

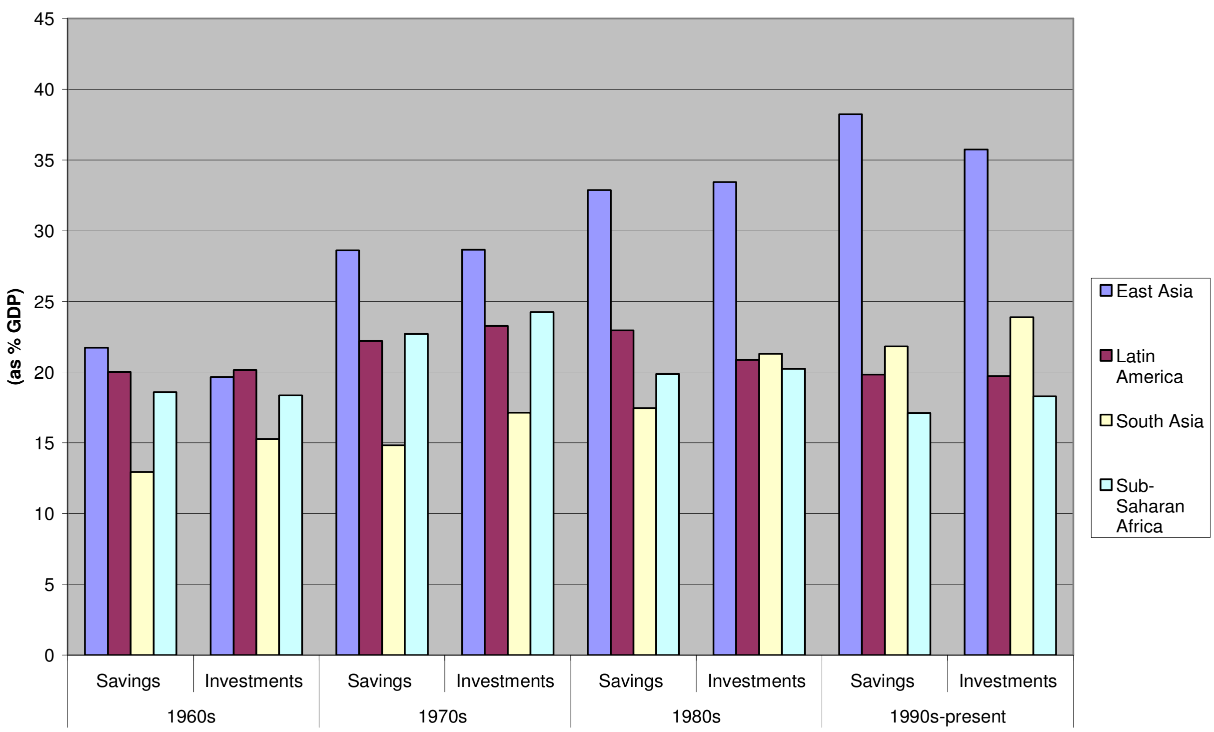
- What are the key policy and institutional drivers of greater DRM?
- What role can aid donors play in facilitating greater DRM?

Each of these questions may be unpackaged in turn.

1. Do countries with greater DRM grow faster or perform better economically?

We start with the assertion that domestically mobilized resources constitute the bulk of the resources that most countries mobilize for investment; the remainder comes from external sources (e.g. aid, foreign borrowing, or FDI)[2]. Therefore, countries with higher domestic savings generally enjoy higher investment rates (see Chart comparing sub-Saharan Africa and other regions of the developing world).

Highly Correlated Savings and Investment



Source: *World Development Indicators* (accessed, March 2008)

The contrast between savings and investment trends in the world's two poorest regions, sub-Saharan Africa and South Asia, is particularly suggestive. Savings and investment have declined in the former and risen in the latter, particularly since 1980. These trends broadly parallel GDP per capita growth trends in the two regions. This suggests raising

[2] We would allude to the "Feldstein-Horioka puzzle" which posits that domestic savings and investment are highly correlated within and between OECD countries. In other words, higher domestic savings are associated with higher investment and growth. However, this does not necessarily lend support to the implication drawn by Feldstein and Horioka, namely that there is little international integration of capital markets, a proposition that has been much criticized in the literature.

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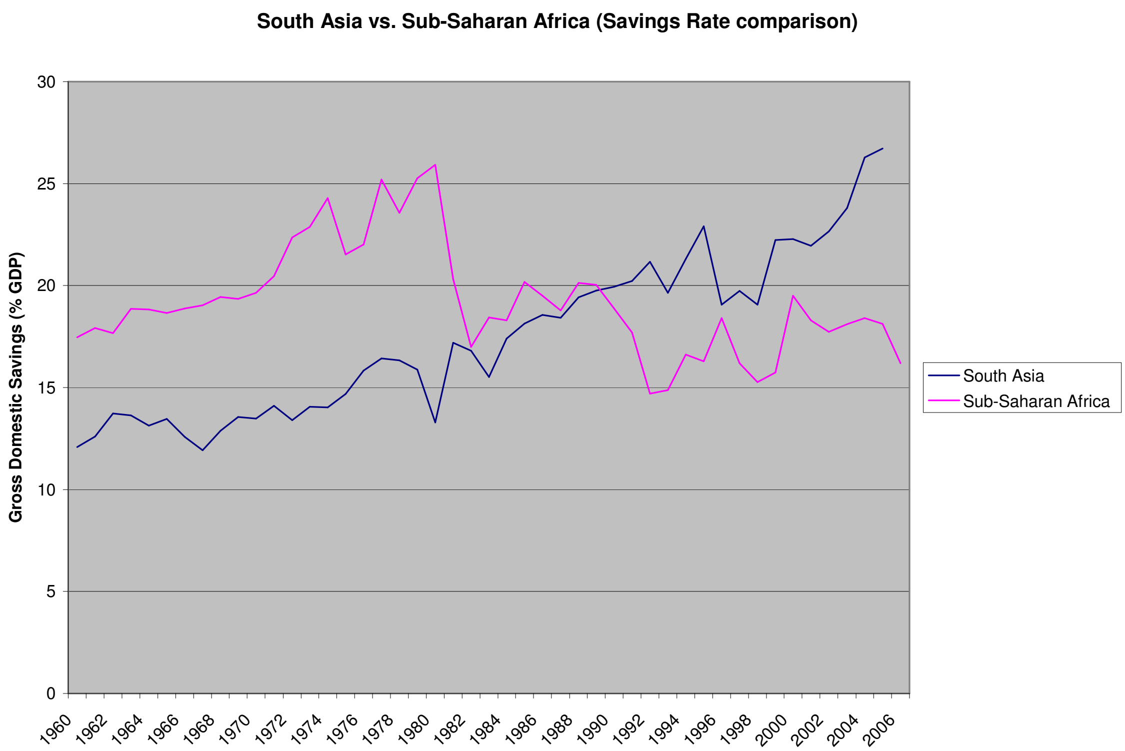
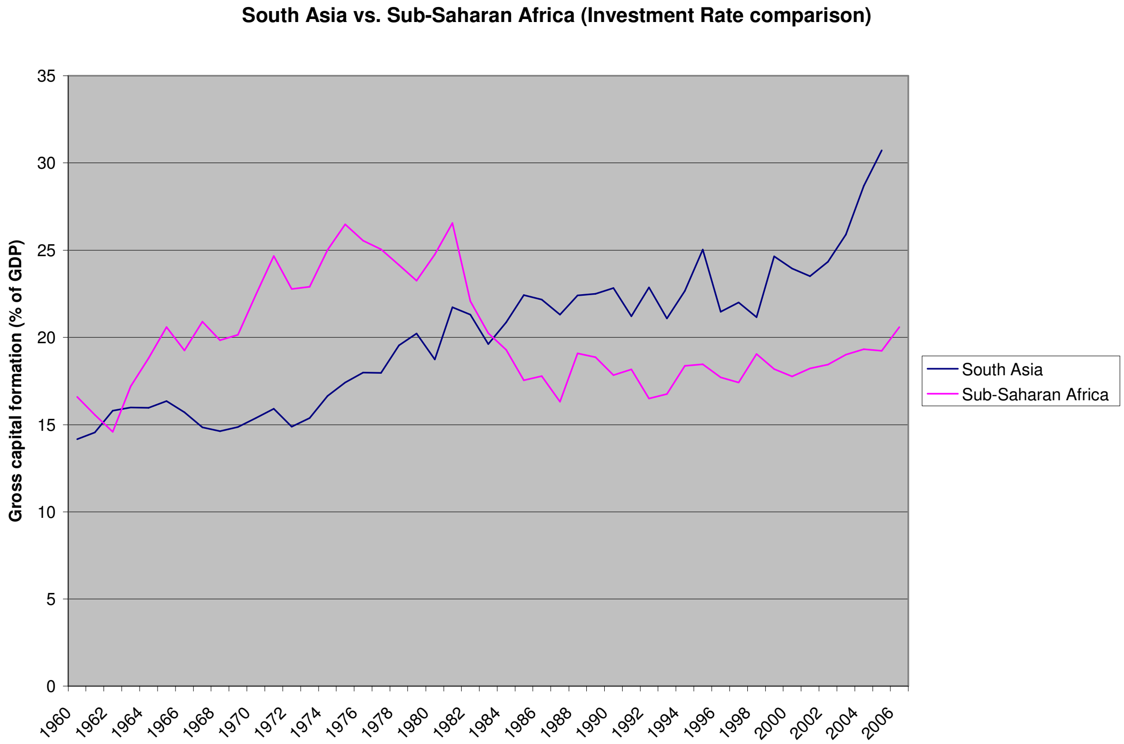
savings and investment levels is crucial for growth even in the poorest regions and while there is significant diversity at the country level, at least part of South Asia's better growth performance than Sub Saharan Africa since the 1980s can be explained by better savings/investment performance.





Source: *World Development Indicators* (accessed, March 2008)

What follows is a very quick tour through the post-World War II literature on the relationship between savings (more specifically investment), on the one hand, and growth on the other, before we revert to the question of how DRM in particular has a strategically important role in boosting investment and growth[3].

There is a considerable literature which analyzes the relationship between investment and growth rates; the following is an extremely cursory summary[4]. In the simple Harrod-Domar model, growth is proportional to the rate of savings and investment. The higher the savings/investment rate, the higher the growth rate. Several problems are associated with the Harrod-Domar model—its very simple production function with fixed proportions between capital and labour, and its implication of economic instability (the problem of "knife-edge" equilibrium)—as well as its implication that the rate of savings/investment is not bounded (in reality it is not conceivable that any economy can save and invest all or even most of its income). Nonetheless, it has led to an enduring notion that countries that save and invest more do grow faster, which is intuitively borne out by available evidence.

However, while the shortcomings of the Harrod-Domar model (fixed factor proportions, unbounded savings) are remedied in the subsequent Solow and Swan (neoclassical) growth model, the rate of savings (and investment) only affects growth in the short run:

[3] Note: earlier contributors to the literature, particularly Schumpeter, made key contributions on the importance of investment and knowledge for the process of growth and development.

[4] Easterly's *The Elusive Quest for Growth* (2001) provides a much more in-depth, if very skeptical, survey of the growth literature.

increased savings (and investment) lead to higher output, but not higher growth rates. Growth is determined exogenously by "technical progress". Solow's well-known empirical results indicated that over 87 percent of growth in output in the U.S. during the twentieth century was on account of technical progress rather than increases in savings (and labour). Under its own restricted assumptions (in particular, diminishing returns) the neoclassical model predicts that all economies will cease to grow and converge toward "steady-state" equilibrium income, where they will remain. Any growth in income beyond this level will depend on "exogenous" technological progress which is universally shared (Solow 1957).

Are the predictions of the neoclassical growth model of convergence toward a steady state, or on the transient effects of savings on growth, at odds with empirical evidence?[5] There is evidence of both convergence and divergence in the past six decades. On the one hand, the experience of the East Asian countries, with their high savings, investment and growth rates, demonstrates a considerable degree of "catch-up" and convergence with the industrial countries. But there is little evidence of any convergence to the zero-growth, "stationary state" predicted by the Solow model[6].

Moreover, the poorest countries (including most of SSA) have laboured under low savings, investment and low or negative growth rates in the 1980s and 1990s (before experiencing higher growth in the present decade) and have diverged from the rest of the world—which suggests that low savings/investment rates *are* constraining growth and that they are *not* benefiting from exogenous technical progress. However, the East Asian experience does suggest that, even if transient, their higher growth rates have had an enormous impact on reducing poverty levels. Hence a lesson for the poorest countries (including most of SSA) from the East Asian experience is that higher savings and investment rates are indeed critical for development and poverty reduction. And if DRM constitutes the bulk of savings for investment, strategies to enhance DRM are critical for development and poverty reduction.

With the work of Kaldor (1962), Arrow (1962), Lucas (1988) and Romer (1986), the literature has moved beyond the neoclassical growth model with exogenous technical progress, which failed to explain continuing divergence for much of the world, and more basically how "exogenous" technical progress occurs. These have led to models of "endogenous" growth (in which the process of technical progress is embedded), anticipated much earlier by Schumpeter, that are very pertinent for domestic resource mobilization for reasons discussed below. By the end of the 1990s, endogenous growth theories represented the mainstream account of growth, articulated by Aghion and Howitt (1998) among others.

[5] Krugman (1994), drawing on the work of Kim and Lau (1994) and Alwyn Young (1994) famously described the "East Asian Miracle" as based more on "perspiration than inspiration", that is, on the rapid increase in investment and employment levels rather than on technical progress. He predicted, consistent with the neoclassical model, that East Asian growth would eventually slow down. Subsequent studies have disputed this conclusion and put considerably more emphasis on technical progress in East Asia.

[6] Easterly (2001) disputes both the validity of the Solow model and of the interpretation of Krugman (et al) on East Asian growth, and goes on to conclude that investment is a relatively insignificant driver of growth.

Essentially, endogenous growth models "embody" technical progress in the rate of investment, instead of assuming that it falls like "manna from heaven" as a free good for all countries, rich and poor alike[7]. In other words, investment continuously embodies improvements based on new knowledge and "learning by doing" so that each generation of capital equipment is more productive than previous generations. Moreover, "investment" is much more broadly conceptualized to include not only capital equipment and machines (as in the Solow model), but also knowledge (investment in human capital), and research and development, which generate productivity increases across the economy. Issues of externalities and the non-appropriability of knowledge are central to endogenous models, suggesting that markets will fail to invest at a socially optimal rate.

Endogenous theories of growth are extremely pertinent for DRM. First of all there is an intuitively clear association between the endogeneity of such growth models and the endogenity implied by domestic resource mobilization. Secondly, they reinforce the notion implied by the Harrod-Domar and Solow neoclassical growth models that increased savings and investment enhance growth (even, according to the latter, only if in the short-term). Thirdly, they draw attention to the strategically crucial role of investment in enhancing growth through productivity increases. In particular, investments directed toward education (investment in human capital), as emphasized by Lucas and Romer, are key. It should be noted that mobilizing and investing in human (as well as financial) resources are integral to the concept of DRM as articulated in the Monterrey Consensus. Fourthly, market failure implies a pro-active role for governments to ensure that investment will occur at a level that is closer to the socially optimal rate.

Finally, we return to the key distinguishing feature of DRM from externally mobilized resources. In the long run, external resources (FDI, aid) cannot typically meet more than a small proportion of any country's overall investment needs and cannot do so in a predictable or sustainable manner. Moreover low-income countries have particular investment needs that are typically not met by external resources—the agricultural sector, for example, has been neglected by aid donors, despite the fact that it represents the sector in which most of the world's poor struggle to make a living. Agriculture, particularly for the local market, also tends to get a low priority among foreign investors (compared, for example, to natural resource extraction, manufacturing, or services such as tourism). Investment in agriculture includes everything from infrastructure (rural roads and irrigation), to R&D on agronomy and biotechnology, to extension services—all of which have been relatively neglected both by external agents and governments in low-income countries.

To sum up, there are compelling reasons, based both on theory and evidence, to believe that a greater emphasis on DRM will enhance investment, productivity and growth in poor countries, thereby making a significant contribution to development and poverty reduction that cannot be made to the same extent and with the same impact by external resource mobilization.

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[7] Technically they also allow the possibility of increasing returns, rather than diminishing returns implicit in the Solow model. Accordingly the dynamics of endogenous models avoid the "stationary state" equilibrium that is a consequence of diminishing returns.

2. How can greater DRM contribute toward reducing aid dependence and increasing policy space/ownership?

Many low-income countries are heavily aid-dependent. OECD/DAC statistics indicate that in 2006, the aid receipts of 22 countries in sub-Saharan Africa and nine low-income countries in other parts of the world exceeded 10 percent of their gross national income. The following table provides some indicators of the extent of aid dependence in a number of low-income countries:

Table
Aid Dependence Indicators
(percent, 2005)

	Aid/GNI	Aid/Gross Capital formation
Burkina Faso	12.9	61.8
Burundi	12.8	378.2
DRC	26.9	181.2
Eritrea	36.9	182.2
Ethiopia	17.4	66.0
Gambia	12.2	50.4
Ghana	12.4	36.0
Guinea-Bissau	39.5	180.0
Haiti	12.1	…
Lao PDR	11.4	32.2
Liberia	54.1	270.9
Madagascar	18.7	82.4
Malawi	28.4	191.1
Mali	13.6	57.5
Mongolia	11.6	31.8
Mozambique	20.7	95.2
Nicaragua	15.4	51.3
Niger	15.2	81.8
Rwanda	27.1	119.5
Sierra Leone	29.6	191.6
Tanzania	12.5	65.8
Uganda	14.0	64.8
West Bank and Gaza	25.0	106.7
Zambia	13.9	50.3
Sub-Saharan Africa	5.5	27.3

Source: World Bank, *World Development Indicators,* 2006

Recipient countries that are so heavily dependent on aid are at considerable risk of losing their policy autonomy. Much aid is tied both as to sources of procurement (typically to suppliers in the donor country) or to uses (tying to specific projects, or constrained by policy conditionality). By definition such restrictions can drastically reduce the policy space and domestic ownership of the recipient country. All the countries in Table 1 had ODA/GNI ratios in excess of 10 percent, and in most of them the ODA/GCF ratio was well over 50 percent. That is, it could be surmised that the bulk of investment is funded by donors in these countries. It is quite possible that donors' priorities dovetail neatly with those of the recipients, but it is more likely that they principally reflect donor priorities on the basis of political or commercial criteria. In the long run, dependence on foreign aid to finance the bulk of domestic investment is not sustainable.

Although many aid donors now espouse untying aid and recognize the critical importance for aid effectiveness of domestic ownership, practice has lagged behind the rhetoric (e.g. in the Paris Declaration). More aid is now being allocated to budget support and program-based approaches. Although in theory such shifts in donor allocations may accord greater domestic ownership to recipients, they also engender other problems not associated with more tied, project-based aid. For example, they may infringe expenditure ceilings or lead to macroeconomic repercussions such as Dutch disease. For this reason, macroeconomic policy conditionality is likely to be reinforced by the trend toward budget support.

There is also a political economy impact of a shift toward greater budget support. A greater proportion of budgetary resources financed by donors reduces the onus on governments and discourages mobilization of public revenues through taxation. It also thereby weakens the linkages and accountability between recipient governments and their taxpayers. If taxation plays a central role in building states and shaping their ties to society, chronic aid dependence weakens the social contract based on bargaining around tax, and institution-building based on the revenue imperative (see Bräutigam, Fjelstad and Moore, 2008).

Greater DRM leading to higher proportions of investment financed through domestic savings, and a greater percentage of the government budget financed through taxation, can clearly reduce the degree of aid dependence. It can thereby contribute toward widening policy space and enhancing domestic ownership (this is a central contention of UNCTAD 2007).

3. What are the key policy and institutional drivers of greater DRM?

Enhancing DRM means generating greater domestic public and private savings for investment. This requires critical policy initiatives and institution-building on the part of developing countries. Key policy arenas include macroeconomic policy, tax policy, the government's expenditure plan (including allocation to infrastructure and other public investment), and the "investment climate". With reference to the latter of these in particular, institution-building is critical to financial sector deepening and strengthening.

Although greater domestic savings and investment must be generated by households, government and by businesses, the principal drivers of enhanced DRM are in the remit of governments, since it is governments that must define and implement policies, and create or strengthen the institutions that are fundamental to a well-functioning financial sector.

Macroeconomic policy is obviously fundamental in establishing the overall climate for domestic savings and investment. For example, macroeconomic policies that fuel high levels of inflation (chronic fiscal deficits, monetary policies that lead to negative real interest rates) undermine the incentive to save and create uncertainty about the future in the minds of investors. On the other hand, stringent fiscal and monetary policies that are excessively targeted on low inflation rates can lead to high real interest rates that inhibit investment in productive capacity and hence constrain growth.

While monetary policy is critical in influencing savings and investment behaviour of households and firms, and private sector investment, fiscal policy has a more direct impact on DRM. On the revenue side of fiscal policy is tax policy. Taxes that are too low constrain government revenues; taxes that are too high constrain private savings (by reducing disposable income or retained earnings) and investment. There are also important administrative issues related to taxation. Taxes may not be collected by revenue authorities or may be evaded by taxpayers. Taxes collected may be vulnerable to corruption. The tax structure may be inequitable or regressive (as with poll taxes).

On the expenditure side of fiscal policy, budgetary allocations to infrastructure or other public investment obviously has a crucial impact on the productive sectors. There are also tradeoffs. Governments that restrain taxes in order to encourage private investment while maintaining fiscal balance may also not have the scope to finance infrastructure, the lack or inadequacy of which may discourage private investment.

More generally the "investment climate", which loosely refers to the conduciveness of the environment for private firms, turns on a number of factors besides the tax regime already mentioned, including the regulatory system governing businesses, the justice system and the enforcement of contracts, and the level of corruption. Greater accountability and transparency of government is often regarded as key to a more conducive investment climate.

Finally, a well-functioning financial system of banks, non-bank intermediaries, and bond and stock markets can only be *created* and *regulated* by governments, although in a market-based system most of the institutions themselves (e.g. banks) are likely to be in the private sector. There are important exceptions—the Central Bank, the custodian of monetary policy (and to some extent exchange-rate policy) is a key public institution, and even if it may operate with a degree of independence from the government, it is still accountable to the government. In addition, institutions to supervise and regulate the financial system, including bond and stock markets, form an important part of the public institutional infrastructure.

In addition, there may be public-private or hybrid institutions, for example development financing institutions that are owned in whole or in part by the government, whose mandate is to lend to or invest in private sector ventures, particularly small and mediumsized enterprises. The history of DFIs, particularly in sub-Saharan Africa, is not very edifying—in the 1980s and 1990s many succumbed to corruption or mismanagement and were phased out as part of the economic reforms and structural adjustment programs of that era. Nonetheless, publicly-owned development banks continue to play a role in many industrial and developing countries, so it is quite conceivable that, if they are managed properly, they could play a role in the poorest countries of SSA as well.[8]

4. What role can aid donors play in facilitating greater DRM?

In general donors do not seem to attach much importance to the objective of enhancing DRM *per se*. This is likely because donors are apt to assume that the aid relationship facilitates greater economic growth, from which will automatically follow greater domestic savings, government tax generation, and higher levels of domestically-driven investment. In this sense, donors' support to ostensibly growth-oriented macroeconomic policies[9] can be seen as implicit facilitation of greater DRM.

Additionally, it is true that donors may indirectly facilitate greater DRM through projects aimed at reforming tax policy or tax administration, or improving governance through reforms of the medium-term expenditure framework and the budgetary process. But by and large donors typically have other objectives in mind rather than DRM.

Moreover donors may undermine DRM through their support of other policies, for example, trade liberalization, which has been shown to undermine tariff revenues in the poorest countries, a key source for governments in low-income countries. Similarly favorable tax treatment and other incentives to attract FDI entail an opportunity cost in the form of foregone revenues. Other examples include the shift of aid toward budget support, which may have the unintended consequence of reducing the incentive of governments to levy and/or collect taxes from its citizens.

The Millennium Development Campaign provides a good example of how donor strategies may unwittingly undermine DRM. Although the time-dated economic and social targets (including achieving universal primary education, including for girls; reducing maternal and infant mortality rates, etc.) are the principal responsibility of the developing countries, donors are heavily involved in supporting specific targets (e.g. the campaigns against HIV, Malaria and TB) without sufficient consideration of local resource mobilization. Ultimately, unless national authorities are able to shoulder the continuing investment and recurrent costs of these initiatives, they may prove unsustainable if aid flows are reduced.

For donors to play a more active and constructive role in facilitating DRM, they must first recognize it as an objective in its own right. Such an objective is entirely consistent with other objectives that are fundamental to donors' aid programs. To begin with, a

[8] These issues are discussed at greater length later in the paper (see: 'Framework of Inquiry' below)
[9] However, the opposite may be true to the extent that the macroeconomic policies supported by donors (typically embodied in Poverty Reduction Strategies approved by the World Bank and IMF) inhibit growth through excessively restrictive fiscal and monetary policies.

compelling case can be made that enhancing DRM enhances economic growth and poverty reduction. Secondly, greater DRM, by definition, increases the ownership of domestic policies and development initiatives in a much more convincing way than lip-service given by governments to policies framed and funded by donors. After all, greater DRM means that governments, households and the private sector are actually raising and committing their own resources toward development.

Finally, donors should conceptualize explicit support for DRM as part of an "exit strategy". In most cases, aid was never meant to represent an unending subsidy or transfer of resources from rich to poor countries. At the same time donors have hoped for, rather than explicitly planned, their exit strategies. Such exit strategies need not, and should not, be time-dated, but more explicitly linked to enhanced DRM by recipient countries. Given growing "aid fatigue" and skepticism about the effectiveness of aid programs in donor countries, the recognition of the need to adopt exit strategies linked to greater autonomy and "self-help" by recipient countries would likely be welcomed by taxpayers in donor countries.

III. Situating DRM in the international policy dialogue: a review of key recent literature

Conceptually speaking 'domestic resource mobilization' (DRM) is a broad subject. Various strata of economic literature cover individual aspects of DRM.[10] This review begins by situating DRM in the recent international policy dialogue literature, beginning with the Monterrey Consensus literature (2002, 2007, 2007a); the implementation reviews carried out by the regional UN agencies (UNESCAP, 2005; ECLAC, 2007; UNECA, 2007) and the UNDESA World Economic and Social Survey (WESS, 2005). Two recent contributions to the literature – UNCTAD (2007) and World Bank (2007, 2008) – significantly advance the DRM agenda. These are reviewed in greater depth.[11] The aim is to highlight key aspects of DRM and regional progress on the DRM front, towards the development of a framework of inquiry.

<u>Monterrey Consensus literature (2002), Secretary General's Follow-up Report (2007) and the High Level Dialogue (2007a)</u>

The roots of the recent literature explicitly on DRM can be traced back to the Monterrey Consensus (MC) document on Financing for Development (2002), wherein Chapter one laid out a nearly comprehensive[12] framework for ensuring "necessary internal conditions" in order to:

- Mobilize domestic savings (both public and private)

[10] E.g. taxation, public finance and expenditure; the banking, financial sector reforms and liberalization literature; the macroeconomic policy literature on inflation targeting and exchange rate management; the investment climate literature etc

[11] Another significant recent contribution is: Mavrotas G, eds. (2008) *Domestic Resource Mobilization and Financial Development*, UNU-WIDER/Palgrave Macmillan. As this is a very recent contribution (published March, 2008) it is not reviewed individually. Earlier versions of individual studies comprising the collection are drawn upon as needed. See also: IMF (April 2008) *Regional Economic Outlook for SSA*

[12] The shortcomings of the Consensus on DRM have been addressed elsewhere. See: Culpeper (2008)

- Sustain adequate levels of investment (public and private sector)
- Increase the capacity of domestic markets and/or establish domestic markets where they do not exist or are too thin (including but not limited to financial markets)
- Fight corruption on all levels
- Increase human capacity (employment generation and labour market policies)

In short, as per the MC framework, DRM comprises:

- Savings mobilization, investment and intermediation;
- Enhancing the efficacy, coherence and consistency of macroeconomic policies;
- Increasing tax revenues and widening tax bases;
- Increasing productivity;
- Reducing capital flight (and encouraging remittances);
- Encouraging the private sector, and
- Making the best possible use of international flows (including export earning, remittances, private investment and official development assistance)

The Secretary General's Follow-up Report (2007) and the High Level Dialogue (2007) expanded on this framework by emphasizing the leadership role that must be played by public policy without which private sector DRM is likely to be weak. The report notes public investment in physical and social capital is imperative if private agents (households and firms) are to elevate their savings and investment levels. Such a leadership role can only be taken if it is also accepted that fiscal space needs to be expanded commensurately. Current fiscal rules have constrained the scope for scaling up public investment, most of all in the poorest regions (sub-Saharan Africa) with critical infrastructure needs. It is now widely acknowledged that "while Structural Adjustment Programs were not specifically designed to curb public investment, adjustment costs fell disproportionately on public investment in infrastructure, particularly in the SSA region, and there are reasons to be concerned on this front" (IMF, 2004).[13]

The 'crowding out' thesis[14], formerly used to justify fiscal restraint, has increasingly come to be challenged. A growing body of empirical literature points to the critical need for public investment in infrastructure particularly in developing countries.[15] A key discussion question for the project therefore is: how can SSA countries mobilize domestic resources for infrastructure investment?

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[13] The average annual infrastructure investment required in SSA in order to meet the MDGs is estimated to be somewhere between 13 percent (Sachs) and 9 percent (Estache) of GDP. This is much more than twice what Africa has spent on the sector over the past 40yrs

[14] The idea is that public spending discourages private investment through interest rate effects and by fostering a non-competitive business environment

[15] Countries that have managed to expand physical infrastructure rapidly are also the ones in which public investment in the sector has played a large and growing role and private and foreign investment interest has been stimulated (e.g. China, Vietnam), whereas in countries that limited the public sector investment role (e.g. Indonesia) the share of FDI in gross capital formation also fell precipitously (Roy, Heuty, Letouze, 2006). See also: (Weeks and Patel, 2003; Roy and Weeks, 2007; McKinley, 2005; Levine, 2005; Gupta, Powell and Yang, 2005; Canning and Bennathan, 2000; Calderon and Serven, 2004)

In recent years UNESCAP (2005), ECLAC (2007) and UNECA (2007)[16] have reviewed the status of the implementation of the DRM chapter of the Consensus in the Asia Pacific, Latin American and African regions respectively. Key issues from these reviews are discussed below.

UNESCAP (2005); ECLAC (2007); UNECA (2007)

UNESCAP was the first to review the implementation of the MC in the Asia Pacific region. While the level of development of DRM processes in the region is quite different from that in Sub Saharan Africa (SSA), several points are noteworthy.

A key issue that is highlighted in the UNESCAP report is the relationship between trade liberalization and DRM. This is important across developing countries as trade taxes still account for the majority of tax revenues in (non resource-rich) developing countries.[17] Globalization and integration has entailed a shift in taxation from 'easy to collect' (such as tariffs, quotas, inflation taxes) to 'hard to collect' taxes (such as VAT, income and sales taxes). The net impact has been revenue losses in several low income countries.[18] Poor countries have found it hard to recover revenues lost due to tariff reduction.[19] Yet the impact of liberalization and transition from 'easy' to 'hard' to collect taxes is by no means universal across developing regions.[20] Therefore the impact of trade liberalization on DRM is a key point for further discussion.[21]

Box.1 Discussion questions: Trade Liberalization and DRM[22]

- In what way(s) has tariff reform impacted the revenue structure in SSA countries?
- Trade taxes still account for the majority of the tax take in several (non resource rich) SSA countries, is there a strategy in place to recover potential lost revenues? What are the estimated effects? What are the potential distributional and welfare impacts?
- What lessons can be drawn from the impact of liberalization on DRM from other parts of the developing world?

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[16] See also: Osakwe P. N. (2008) and UNECA (2008), *Africa and the Monterrey Consensus: Tracking Performance and Progress* (forthcoming)
[17] Trade taxes account for a much larger share of total tax revenue in developing countries (24.9%) as compared to developed countries (0.5%) and transitional economies (6.2%); the percentage for Africa is highest (33%) among developing regions (Fitzgerald, 2007)
[18] Losses are estimated at a sizable 16.9% drop in the tax/GDP ratio (Aizenman and Jinjarak, 2006)
[19] Low income countries have recovered no more than 30 cents of each lost dollar due to tariff reduction, and are still dependent on trade taxes (Baunsgaard and Keen, 2005)
[20] For instance, while low income countries in general find it hard to transition from 'easy to collect' to 'hard to collect' taxes, in South Asia the large increase in revenue from 'hard to collect' taxes more than offset the drop in the revenue and increased the total tax take by 4.5 percent. Revenue from 'easy to collect' taxes (seigniorage and tariff) fell 17.1%, but revenue from 'hard to collect' taxes (income tax and VAT) increased 41.1% from 1980-84 to 1995-99
[21] An obvious entry-point is the impact on taxation and revenue structure, but other aspects such as the potential indirect impact on private investment and productivity should not be discounted
[22] **NOTE: The purpose of the questions in boxes is to animate discussion at the first working meeting. Some of these maybe picked up as specific country-level research question where applicable**

While not specifically a review of the implementation of the MC, the ECLAC (2007) study of the determinants, constraints and policies affecting savings in Latin America touches on several points of interest. For instance, ECLAC finds no evidence of association between national savings and the level of income (per capita GDP), dependency ratio, domestic interest rates, terms of trade, and income distribution. The study suggests mutual causality between national savings and growth, and does not indicate growth 'causes' or 'drives' savings.[23] ECLAC also finds national savings and investment rates are highly correlated and foreign savings tend to be more volatile than national savings. Latin America's experience shows that excessive reliance on foreign savings is at the center of currency and financial crises. The main implication of the study is that even in a world of liberalized capital and trade flows, proximity and access to large developed markets; domestic mobilization, intermediation and accumulation processes are inevitably the main drivers of economic growth and transformation.

The finding which is of interest to us from the ECLAC report is that sustained growth seems to require both raising national savings and productivity. In cases of productivity constraints, growth (through the enhancing of investment returns) would drive savings, as distortions affecting productivity growth make additional savings less effective for accelerating growth. In cases of investment financing constraints, savings would drive growth, as alleviating borrowing constraints would increase the financing required for raising investment. This provides a good entry-point for discussion into whether productivity or investment financing constraints are a greater barrier in SSA.

Box.2 Discussion questions: Binding constraints

- In relative terms, as far as 'binding constraints' are concerned, in the SSA context are productivity constraints more important or investment constraints?
- Is this is a useful analytical dichotomy?
- Are constraints different across sectors (e.g. agricultural productivity; or infrastructure investment financing)?
- Do other more fundamental constraints (e.g. low levels of monetization; lack of incentive to participate in the 'formal' economy; high entry barriers) present greater challenges?

Economic Performance								
Region	1960-74		1975-84		1985-2000		1960-2000	
	GDP per worker	TFP	GDP per worker	TFP	GDP per worker	TFP	GDP per worker	TFP
Sub-Saharan Africa	1.80	0.83	-0.76	-1.84	0.07	-0.08	0.51	-0.09
Latin America, Caribbean	2.33	1.44	-0.62	-1.76	0.11	-0.27	0.76	0.00
South Asia	1.82	0.39	2.52	1.15	2.32	1.04	2.18	0.82
East Asia, Pacific	3.83	1.18	3.77	0.71	4.04	1.58	3.89	1.21
Middle East and N. Africa	3.75	1.86	2.50	0.37	0.92	0.13	2.37	0.84
Industrialized countries	3.49	1.75	1.15	0.01	1.70	0.80	2.33	0.96
(TFP: Total Factor Productivity)								

Source: UNCTAD (2007)

[23] This contrasts much of the recent literature on the topic e.g. WESS (2005) reviewed below and the influential World Bank study Loayaza et. al. (2000)

In 2007, UNECA undertook a survey of the perspectives of African policymakers on the implementation of the MC. Policymakers noted, 'although significant progress has been made in areas such as external debt, performance in international trade, external and domestic resources mobilization is far below expectation'. Savings and investment rates in SSA improved, but only modestly, and are well below the region's MDG investment requirements.

Respondents noted national economic policies have been 'moderately supportive' of DRM and that while a substantial majority of countries have a national development strategy to mobilize domestic resources, almost 60 percent stressed that implementation has either been low or completely absent. To summarize, the main obstacles to DRM noted were: weak financial infrastructure, governance and corruption. The main obstacles to the use of capital markets for savings mobilization were: limited investment instruments, weak capital market infrastructure, lack of access to information and low expected returns. These responses are not surprising, but they do provoke the question: relative to other sources of finance for development, what is the level of priority SSA policymakers devote to DRM?

Box.3 Discussion questions: DRM in the SSA policy agenda

- Have SSA policymakers prioritized DRM as a means of development financing (relative to say, attracting FDI or ODA)?
- What national strategies are currently in place with regards DRM?
- What are the main reasons behind lack of implementation?
- What is (or should be) the role of the state and its development partners (regional e.g. AfDB, multilateral e.g. IFIs, and bilateral donors) in financial market infrastructure development?
- What role could private sector participants (in particular, foreign banks and non-banking financial institutions operating in SSA) play in financial sector infrastructure development?
- Given the constraints of SSA financial markets, what are the kinds of investment instruments that would be relevant, both in terms of mobilizing and pooling savings, and risk diversification?
- What is the realistic potential of alternatives and innovations, such as micro credit in consolidating the otherwise highly fragmented financial markets in the region?
- Are there structural limits to what can be achieved (e.g. market density, income levels, financial education levels, urbanization levels, real returns and risk perceptions)? How can these be overcome?

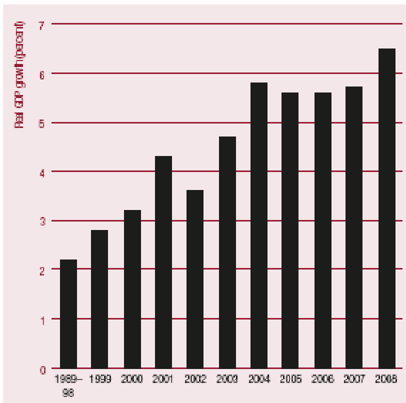
African Development Bank, High Level Report (2007)

The recent AfDB High Level Report, "Investing in Africa's Future", highlights the continent's laudable performance over the past decade[24] and articulates a bold vision for 2030. This vision is one of significant poverty reduction through the development of both

[24] See graphs (next page). In addition, external debt has declined from 65% of GDP to under 20%; the debt service ratio has improved from over 20% to just over 5%. Strong macroeconomic performance is also reflected in poverty impact: for the first time in at least a quarter century the number of poor people in SSA has not increased

physical and ‘soft’ infrastructure[25], in a strong, stable and well integrated continent with thriving domestic economies (AfDB, 2007).

Real GDP Growth (SSA)

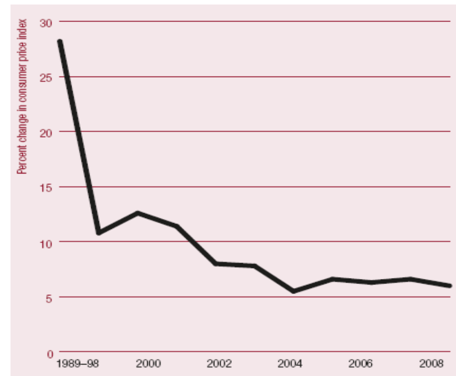


Source: AfDB (2007)

Fiscal Balance (SSA)

Source: AfDB (2007)

Inflation (SSA)



Source: AfDB (2007)

However, the AfDB report also notes that big challenges lie ahead of SSA; continental averages disguise wide variations across countries and increasing disparities within countries. Progress in many countries remains fragile. ‘If substantial and coherent efforts are not made in order to harness the present upswing towards deeper structural transformation, today’s progress would be remembered as just another phase in another commodity boom-bust cycle’ (AfDB, 2007).

Box.4 Discussion questions: Harnessing the present

- How can the recent upswing in many SSA countries be harnessed to enhance DRM institutions and processes?
- Where does public investment fit into an agenda that seeks to enhance DRM?
- What role can (and should) the state play in financing the generation of economic, social and physical infrastructure?
- Is it realistic to think that an appreciably greater proportion of resources for investment in infrastructure sectors can be mobilized domestically in SSA? What strategies (e.g. holding companies) and models (e.g. public-private partnerships) might work, and how should these be structured?

The Monterrey Consensus framework, the regional implementation review literature and the AfDB High Level Report have helped situate DRM in a wider international policy dialogue context. While the impact of the ongoing crisis in global capital markets (in particular credit markets) on developing countries and access to finance for development remains to be investigated, the prevailing global climate further strengthens the case for focusing on DRM in developing countries.

[25] E.g. social and economic institutions

UNDESA, World Economic and Social Survey (WESS, 2005)

The United Nations Department of Economic and Social Affairs (UNDESA) devoted its 2005 World Economic and Social Survey (WESS) to a chapter by chapter review of the six Monterrey actions. The review takes a global perspective and provides a useful discussion of some of the key theoretical issues underpinning DRM.

The relationship between savings, investment and growth is at the center of the DRM agenda. WESS (2005) notes that raising the savings rate was formerly seen as necessary to achieve economic take-off, however more recent analysis has emphasized investment, innovation and productivity improvements. Raising savings and directing them to productive investment is crucial but should not be the main focus of a DRM strategy.

In contrast to ECLAC (discussed above), WESS (2005) definitively states the direction of causality flows from growth to savings. Growth causes savings, rather than the reverse, therefore policy recommendations should concentrate on the broad determinants of growth.[26] WESS finds most investment in developing countries is driven by domestic savings and experiences in mobilizing external savings have varied greatly. Much of the report emphasizes capital market development and improvement of the domestic investment climate in developing countries.

An essential part of improving the investment climate is improvement of physical infrastructure and a focus on production sector strategies. Similarly, macroeconomic stability is critical to the investment climate, but the concept must also take into account real stability in output and employment (as it does in advanced economies). WESS (2005) suggests that investments in the improvement of the legal and regulatory framework, in particular labor regulation and social protection, can be viewed as an investment in the improvement of the investment climate.

Capital markets play a key role in intermediating savings into investment and as signals of the investment climate. Development of capital markets can contribute to financial stability[27] and can play an important role in enhancing the volume and quality of DRM. Measures to encourage bond markets can also enhance DRM.[28] However institutional

[26] This is consistent with the much cited World Bank study Loayza, Schmidt-Hebbel and Severn (2000); Elbadawi and Mwega (2000) similarly find that in SSA causality runs from growth to investment (and perhaps to savings), and a rise in savings causes an increase in investment. The same study argues the reasons for low-savings in the region are low per-capita income, higher young-age dependency and high dependence on aid; for an explanation of why savings rates are much higher in India compared to other developing regions despite low per-capita income see Loayaza and Shankar (2000); see also Rodrik (2000) on savings transitions

[27] This of course cuts both ways as volatility is an inherent feature of capital markets. But it is notable that development of capital and other asset markets can also act as de facto 'inflation curbs' especially in periods of rapid transition from low to high levels of monetization and from non-financial to financial savings. The recent experience of China (and less so India) are good examples of this (see: WESS, 2005 and Watanabe, 1998)

[28] Domestic bond markets are at a nascent stage of development in SSA. One recommendation is the development of regional bond markets that overcome the scale and diversification problem (Kahn, 2005). Encouraging signs of change can be found recent years, e.g. at least three African countries and one private

factors, governance issues and concentration in the corporate sector affect the development of capital markets in developing regions. Interestingly, WESS (2005) finds that the financial sector tends to become more pro-cyclical with liberalization. There is merit therefore to thinking about forward-looking (provisionary) and discretionary counter-cyclical measures, and the preconditions required to make these possible in developing countries.

A number of issues covered in WESS (2005) have been raised in the literature discussed above and together these lend themselves to a framework for analyzing DRM which we discuss in Section IV (A framework of Inquiry).

The aim of the discussion to follow is to help contextualize DRM in the SSA region. The next two sections discuss in greater detail key points that emerge out of two significant contributions to the DRM literature specifically on SSA. The first 'Reclaiming Policy Space' is the output of a three-year UNCTAD research project (2006 – 2009).[29] The second, 'Making Finance Work for Africa' (World Bank, 2007) makes a significant contribution to our understanding of the factors affecting the financial system in the region.

UNCTAD (2007)

UNCTAD began a three-year project on DRM in Sub Saharan Africa in 2006. The project, still ongoing, is aimed at developing national level strategies in order to mobilize non-debt creating domestic financial resources for development.

The key message of the study is that the necessary ingredients are in place in African countries to tackle their developmental challenges within the framework of a "developmental state".[30] The report provides an interesting comparison between SSA and East Asia, particularly with reference to the role of the state in enhancing DRM. It is notable that this question – of the potential for the emergence of 'developmental' states in SSA – has received renewed attention in much of the recent development literature.[31]

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bank have been able to raise local currency debt overseas (see: 'On Safari' Dec, 13th 2007 Economist print edition and also Euvin Naidoo, 'Africa as an investment' http://www.ted.com/talks/view/id/154)

[29] A key deliverable of the project is the UNCTAD Handbook on Enhancing the Role of Domestic Resources in Development. The North-South Institute is coordinating efforts with UNCTAD in order to extend the handbook series to the case-study countries in our project. This will provide an important dissemination platform for the research findings

[30] This is based on recent achievements in the area of macroeconomic stability and a newfound democratic dispensation across several SSA countries

[31] Sindzingre (2007) notes: the developmental state is strong not because it owns and controls, but because it has the capacity to make credible commitments (promises as well as threats), to change property rights and to provide incentives for both private and public agents, albeit in a coercive manner. In percentage terms, there is little difference between East Asian and SSA countries as far as public sector revenue is concerned (tax/GDP). However, an important feature of Asian developmental states was that they tried to avoid a prolonged use of foreign aid and technical assistance (which are more volatile than domestic revenues and which tend to erode domestic incentive structures, political institutions and state legitimacy). See also: Mkandawire (2001); Ndikumana (2006); Bidrsall (2007); on volatility of domestic revenue vs. aid flow see: Bulir and Hamann (2003; 2005) and Khan (2007)

The UNCTAD report focuses on several key aspects of DRM; these are reviewed below in a thematic fashion under the following headings:

- Savings
- Formal financial sector performance
- Impact of liberalization and reforms
- Banking sector and capital markets
- Public revenue
- Capital flight

Savings

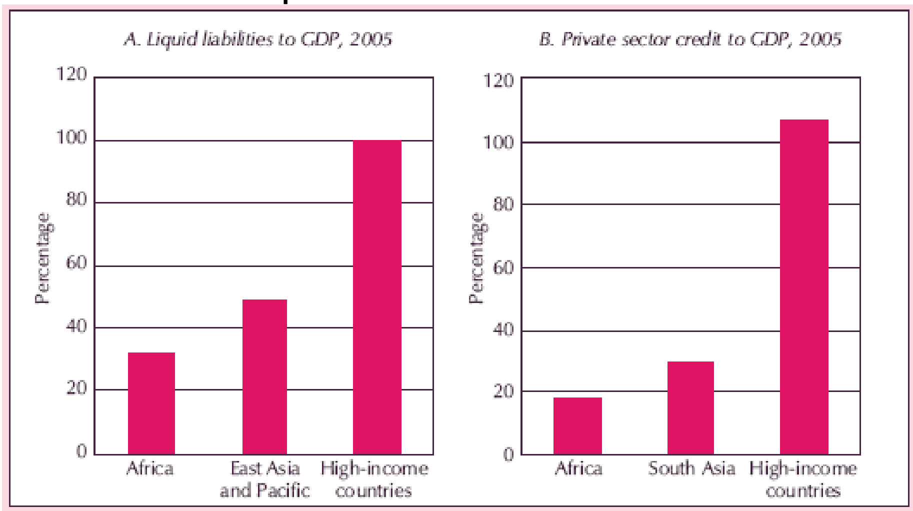
Raising savings rates from present levels is an important issue in the SSA context. However gross savings rates are not necessarily reliable indicators of domestic resources available for investment, because savings figures are tentative as they are derived as a residual in the national accounts from expenditure and production data that are themselves quite unreliable (Aryteetey and Udry, 2000). Notwithstanding this, it is clear that household savings dominate savings in Africa. However, these are not sufficiently channeled into investment, in part because non-financial assets account for the majority of household assets in rural areas and often assets such as livestock, goods, grains and construction materials offer a higher return on investment that available financial assets (UNCTAD, 2007; Aryteetey and Udry, 2000).

Corporate savings has received less attention in SSA due to lack of sufficient data. Firm and sector level surveys do however suggest that large firms are much more likely to obtain credit. Access to credit and the cost of credit are major impediments. As a result, firms depend on retained earnings to fund not only working capital but also new investment. This constrains firms from evolving from small-medium and micro enterprises into large complex operations. Lack of credit and insurance means savings are kept in a highly liquid form and therefore not reinvested by the financial sector.

Formal financial sector performance

Africa has one of the lowest rates of access to formal financial services of any developing region. Only about 20 percent of households have access to formal financial services. The formal financial sector is performing poorly. Both in terms of liquid liabilities to GDP (32 percent) and private sector credit to GDP (18 percent) SSA lags far behind other developing regions such as South Asia (49 percent and 30 percent) and East Asia (100 percent and 107 percent).

Basic Indicators of Depth and Intermediation



Source: UNCTAD (2007), Honohan and Beck (2007)

Financial Performance Indicators (2006)

	Domestic credit to private sector (% of GDP)	Interest rate spread (lending rate minus deposit rate)
East Asia & Pacific	99.67	5.73
Latin America & Caribbean	31.55	7.42
South Asia	43.36	6.66
Sub-Saharan Africa (including South Africa)	43.99	9.61
High Income	161.77	4.40

Source: World Development Indicators

Banks are concentrated in urban areas and they often have incentives, rules and procedures[32] that prevent poorer households and small businesses from gaining access to their services. Relative to large economic and non-economic shocks, and idiosyncratic risks linked to borrowers, banks' risk management capacities are very limited.

Impact of liberalization and reforms

In part to remedy these problems, many African countries underwent financial sector reforms starting in the mid-1980s. These included financial liberalization and institutional reforms to prudential regulation systems and distressed government-owned banks (Brownbridge and Gayi, 1999). It can be argued however that where reforms succeeded in their first objective of limiting the scope of government intervention in the financial sector and strengthening prudential regulation; they have failed with respect to deepening and diversifying the financial sector. It is this second aspect of financial sector reforms that should now be the starting point for discussion, specifically from the perspective of developing the financial sector to enhance DRM.

[32] Such as minimum deposit and balance requirements, low deposit rates, and high collateral requirements and interest rates for loans

Reforms, still ongoing in many countries, as a general consequence have made the financial sector more responsive to the application of purely commercial principles. As a result development banking (DBs) and development finance institutions (DFIs) have been the main casualties of the process, increasing pressure on the long term credit front. There is a need to bring fresh thinking into the role of the formal financial sector in integrating domestic economies in SSA and widening access to financial services by developing linkages with institutions such as microfinance (UNCTAD 2007; Garson, 2006; Ndikumana, 2006).[33]

As reforms are part of wider macroeconomic stabilization programs it would be premature to pronounce definitive success or failure. Viewed from the bird's eye view of aggregate growth rates, inflation rates, debt service and fiscal deficit containment it is possible to argue that the effect of the reforms has been positive.[34] On the other hand it is hard to deny that the financial sector is still unable to respond to the developmental needs of SSA countries. Persistently low savings levels and excess liquidity in the banking system are particularly worrying (see next section).

The DRM implications of financial sector liberalization in SSA have recently been explored in the empirical literature. Serieux (2008) and Serieux and McKinley (2008) compare the performance of 19 countries for the period before liberalization or 'financial repression' (1965-1985) and that afterwards (1996-2005) using regression analysis to identify impacts on private and public savings, private investment, the liquidity ratio, credit to the private sector, and economic growth.

Serieux (2008) concludes liberalization has modestly reduced the substitutive relationship between public and private savings and increased the correlation between private credit and investment. Liberalization is negatively correlated with both liquidity and private-sector credit expansion and has had no effect on growth. In short, the overall effect of liberalization on resource mobilization has been ambiguous and marginal. These results point to the need for deeper structural changes—beyond financial-sector policies—in order to substantially improve resource mobilization in sub-Saharan Africa.

It is also important to highlight that over the years SSA countries have been subjected to reforms based on all manner of intellectual persuasion. Excessively deflationary policies have placed SSA countries on a low growth path which has discouraged investment, trade diversification and undermined the investment-growth nexus (Mkandawire 2005). Monetary policy has been excessively focused on inflation targeting to the detriment of growth objectives. As mentioned, significant progress has been made on the short-term macroeconomic stabilization front in several SSA countries, the focus of monetary and fiscal policy must now widen to include long-term growth and structural change objectives.

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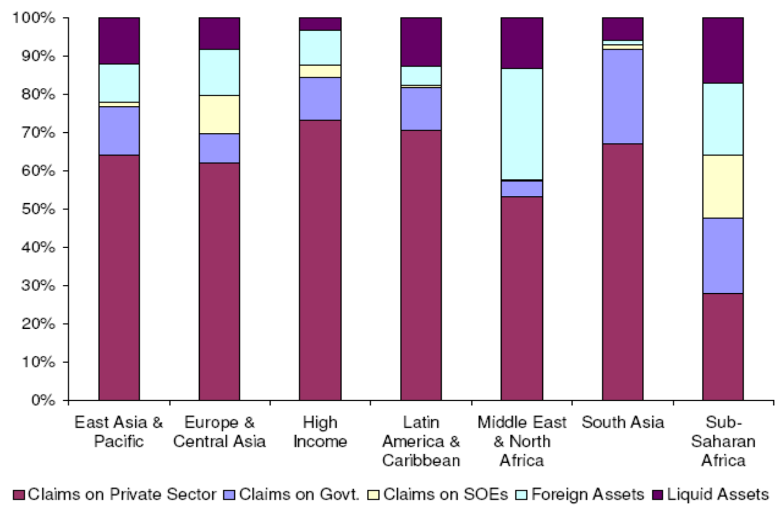
[33] See also: *Rethinking the Role of DFIs in Post-Liberalization SSA*, UN Finance for Development website: http://www.un.org/esa/ffd/msc/ffdo.htm

[34] For more on this view, see: ADI, 2007; BBC News Africa, 2007; AfDB, 2007. However the question is to what extent growth, inflation and deficit performance is a product of reforms and to what extent a consequence of high global growth, low global inflation, and strong demand for African resources

Banking sector

Despite significant reforms banks still prefer to lend to established firms and foreign affiliates in SSA.[35] Post-liberalization, access to financial services in non-urban areas has deteriorated.[36] The sale of government debt to finance the budget means that most banks hold their assets in government paper (treasury bills), which carry virtually no risks. Lack of competition in the financial sector largely explains very high real interest rates (despite low and falling inflation) and high spreads. Far from being a settled issue this is an important point of debate.[37] The lending–deposit rate spread in Africa is higher than in other developing regions.[38] These factors have combined to create a peculiar picture: the majority of the population lacks access to credit, the private sector is credit constrained and the financial system is highly uncompetitive and inefficient; yet, bank liquidity ratios in some cases are upwards of 150 percent and one of the least competitive banking sectors in the world is also the most profitable.

Asset Composition of Banks across Regions



Source: Honohan and Beck, 2007

[35] The reasons are fairly obvious: high default risk stemming from lack of collateral and lack of credit history of most local enterprises, weak legal and regulatory systems that render foreclosure arduous and time consuming

[36] The somewhat ironic exception here is that liberalization seems to have been beneficial for the micro-finance industry, which has in part picked up some of the slack. See: UNTAD (2007) and World Bank (2007)

[37] Additional reasons given for high spreads are low efficiency and high overhead (admin and monitoring) costs in the sector (Honohan and Beck, 2007).

[38] Demirguc-Kunt, Laeven, and Levine (2004) analysed structural factors that drive interest rate differentials in less developed financial systems and found the most important factor was 'quality of property right protection' (which leads to higher monitoring costs), followed by inflation and bank size. Higher administrative costs explain the majority of the differential in SSA; small size, macroeconomic instability, lack of competition, very high levels of concentration were also important determinants. In sum, the major factors relate to the informational environment, systemic risk and lack of scale. See also: McKinley, 2005 on the growth impact of interest rates; and UNCTAD, 2007 on the impact of high interest rates on microfinance (p.37) and on fragmentation of financial markets and corporate credit (Chapter 2)

Bank profits by comparison		
Region/bank	Return on Assets (%)	Return on Equity (%)
Africa	2.1	20.1
Sub-sample of Foreign Banks in Africa	4.7	43.2
Rest of World (ROW)	0.6	8.5
Foreign Banks in ROW	0.9	8.6

Source: Honohan and Beck, 2007 (Original authors calculation using BankScope)

Bankers admit that in a remarkable number of African countries it is not by a lack of mobilized funds that they are constrained. African banks are highly liquid, but investment is low. Excess liquidity coincides with limited monetization: the population is unwilling to save in monetary form *and* banks are unable to lend out even the limited resources that they have. Some of this trend reflects capital restructuring of failed banks which saw their loan book written down or removed. But it clearly indicates either a problem with generating sufficient satisfactory loan business or a response to perceived liquidity risk. The banking sector generally points to the former and complains about the lack of "bankable" demand for credit.

Asset-liability and maturity mismatches add a further dimension of complexity. In terms of deposits, most banks attract only short-term deposits which can not be used to fund long-term investments, particularly in risky environments. Mismatch in the term structure of savings and investment requirements implies many countries have difficulty transforming savings into investment. As short-term paper dominates debt markets in Africa – three month bills account for nearly 50 percent of the debt stock – governments roll over half the debt four times a year. The average maturity for African countries is only 231 days, compared to 720 days for Mexico, 1085 days for Brazil and 3050 days for India (Christensen, 2004).

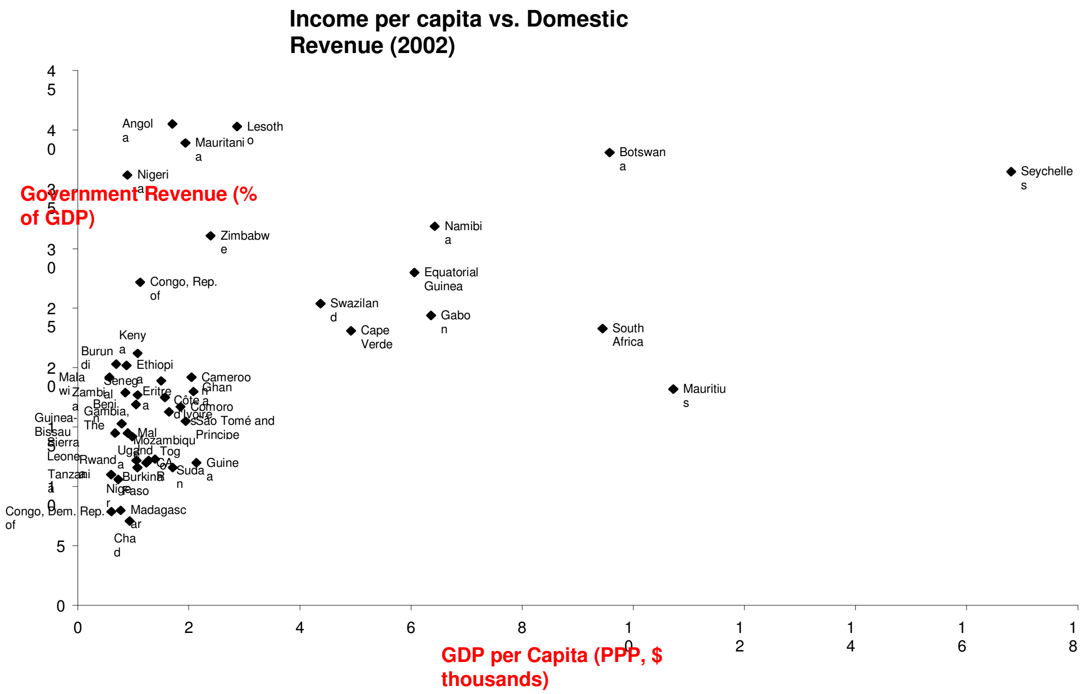
Public revenue

The other side of the DRM coin is public sector revenue. The main determinants of the tax/GDP ratio in SSA have been found to be per capita income, trade levels and the shares of agriculture and mining in the economy (Stosky and WoldeMariam, 1997; UNCTAD, 2007). Per capita income has been found to be positively related to higher tax ratios (though this has been decreasing in recent years due to trade liberalization); trade levels are found to be positively correlated with higher tax ratios; the share of agriculture is negatively correlated with the tax ratios; and the share of mining has also been found to have a negative effect on taxes (Stosky and WodeMariam, 1997).

Using more recent data Mills (2007) finds a number of SSA countries have made major improvements in revenue collection in recent years.[39] Mills (2007) finds only a weak positive correlation between per capita income and revenue mobilization, which can be

[39] During the 1994 to 2002 period, Nigeria's domestic revenue increased by 17.7% of GDP, Mauritania's by 14.6% of GDP, Equatorial Guinea's by 10.7% of GDP, Cameroon's by 9.3% of GDP and Rwanda's by 9.9% of GDP – all significant improvements. While the first four can be explained by oil revenue surges, Rwanda's case is explained by strong economic recovery and tax reforms

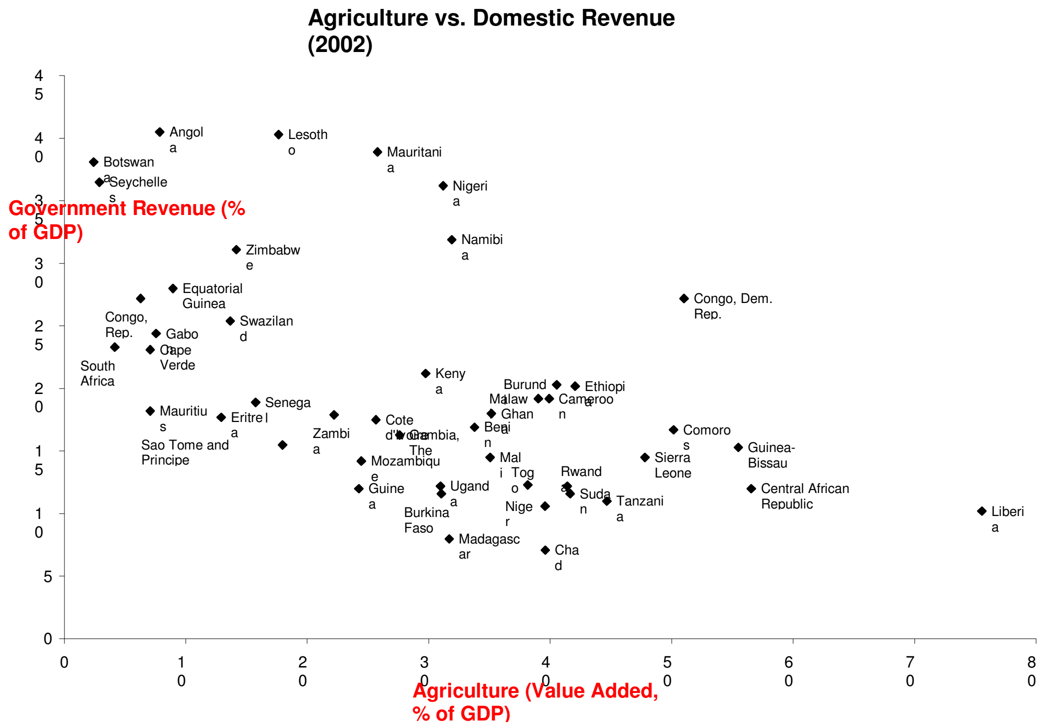
explained by widespread tax evasion, weak tax administrations, and high inequality. There was a clear negative relationship between the share of agriculture and revenue mobilization.[40] Aid is found to have a negative effect on DRM.[41]



Source: Mills, 2007

[40] Explained of course by the fact that countries with relatively low agrarian bases by definition have higher service and industrial bases, which are easier to tax; furthermore, several low agrarian share counties are also resource rich

[41] But one must be mindful that aid generally flows to the poorest countries which require additional assistance to finance government expenditure. The aid-DRM literature is reviewed later in this survey



Source: Mills, 2007

High revenue SSA countries derive the majority of their revenues from non-tax sources (e.g. royalties); international trade taxes are the dominant source of revenue for more than half of the countries and taxes on goods and services account for the main source of government revenue in a third of the countries.[42]

However, the key finding is that for non resource rich countries the most important determinant of revenue level is the development of a well-functioning and implementable tax system with an efficient tax administration.[43] While revenue surges, such as in Ghana, Uganda and more recently Tanzania are encouraging, enhancing DRM is not simply about raising revenue, but equally about 'how' resources are mobilized and the 'quality' of the resource. Revenue growth, desirable as it may be, should not come at the cost of regressive taxation, which has been the case of some of the recent tax reforms (particularly VAT).

There are other constraints to tax mobilization. The social contract on which taxation is based is absent in many SSA countries. Majority of the population has low taxable capacity that is costly to collect especially in rural areas. Even where citizens are willing to pay taxes, perceptions of misuse of funds by the state create an atmosphere of distrust (Fjeldstad and Rakner, 2003; Fjeldstad, 2006).

[42] South Africa is the only exception which derives more than half of its public revenue from direct taxes
[43] This is based on a case study of Ghana and Uganda. Ghana's revenue level nearly quadrupled from 1981 to 2005, Uganda's revenue level doubled from 1988 to 2003 following major tax administration reform in both countries

Not only taxation, but how the population is taxed is also important. Reforming revenue collection is a priority. There is evidence that low compliance is related in part to forms of coercion (Fjelstad and Semboja, 2001).[44] The need is to build consensual tax systems. While reforming the tax system is an essential part of improving DRM, it is unlikely to succeed in the absence of more profound changes to state–society relations.

Tax issues have been relatively absent from the political agenda in the developing world. As a consequence governance has suffered as it is not rooted in domestic policy demand. Many governments do not need to make much tax effort because they have large non-tax incomes from oil, gas and mineral exports or from foreign aid. The long term consequences are detrimental to good governance. State elites are less responsive and accountable to citizens and may have less incentive to build up the political and organizational capacities of the state. Therefore states end up simultaneously arbitrary and weak (Moore, 2004; Moore, 2007).

It is imperative that we develop a deeper understanding of the linkages between taxation (and other sources of public revenue) and DRM. Some preliminary questions that emerge are as follows:

Box.5 Discussion points: Public sector revenue enhancement

- Will increasing taxes in poor countries lead to greater revenue mobilization?
- Should SSA countries prioritize enhancing DRM through increased taxation?
- If so, what kinds of taxes or which sections of the tax base should to be targeted?
- Rather than increasing tax levels, how can the tax base be broadened in order to enhance revenues?

Conclusive answers are complicated by the paucity of relevant data. On a more fundamental level however, given the high percentage of economic activity in the 'informal economy' in most poor countries, it is entirely possible that an increase in tax rates might push further sections of the productive economy into the 'informal' sector and thus out of the tax base altogether (UNCTAD, 2007; Dabla-Norris, Gradstein, Inchauste, 2008). On paper, the average total tax on business in SSA is already one of the highest in the world.[45] However this does not translate into higher collections and a significant share of revenues is lost to capital flight and uncollected taxes.

Capital flight

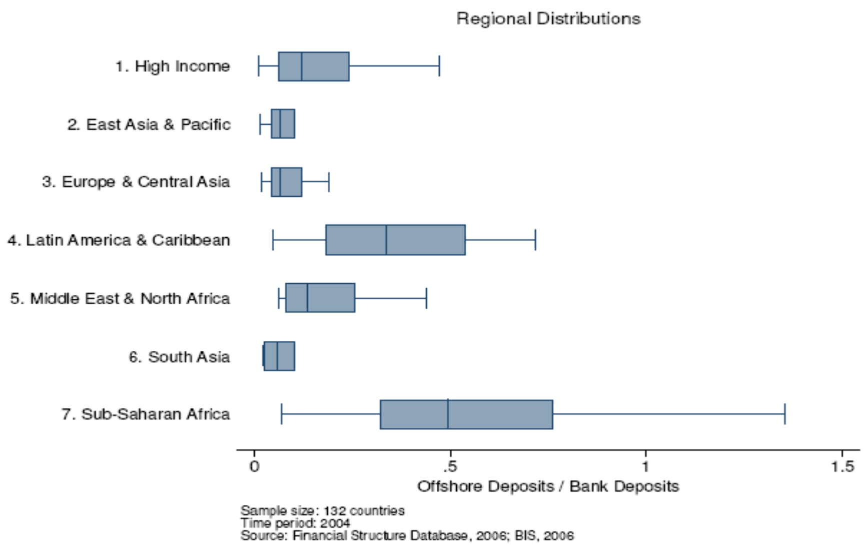
Capital flight denies SSA anywhere between 5 percent (Ajayi, 1997) and 7 percent (Salisu, 2005) of GDP. Capital flight can be seen as the ultimate reflection of a country's failure to mobilize and retain its domestic financial resources (UNCTAD, 2007). As capital flight is essentially a decision to hold assets abroad rather than within the country it is responsive to macroeconomic and political instability, financial market depth,

[44] Brautigam, Moore et al. (2008) provide the example of the notorious "poll tax" as a coercive, inequitable and much detested form of coercive taxation in many SSA countries, which undermines the willingness to contemplate new or additional taxes

[45] Estimated at 68 percent of profit compared to 41 percent in S. Asia and 46 percent in the OECD (Everest-Phillips, 2008)

investment climate and other factors affecting risk adjusted returns. However, much of the capital flight has taken the form of ill-gotten gains by an assortment of individuals rather than rational portfolio behavior. Addressing this form of 'illegal capital flight' requires greater transparency by offshore financial centers where all non-resident deposits and investments are held. This would help identify and distinguish illicit capital from the magnitude of 'rational' capital flight.[46] Given the significant magnitudes involved and ambiguity surrounding immediate policy responses, capital flight is an overarching DRM constraint in SSA.

Offshore Bank Deposits



(Plots the minimum, maximum and median of ratio of offshore to domestic deposits; shaded area is interquartile range. Outliers omitted. Data: 2005). Source: Honohan and Beck, 2007

Strategies aimed at addressing capital flight and inefficient domestic allocation of capital would go a long way in both building confidence and raising productivity.[47] They might also help turn around the domestic investment climate. One approach would be to conduct a preliminary SWOT analysis[48] of the investment climate at the country level.

Box.6 Discussion points emerging out of UNCTAD (2007)

- How reliable are data on domestic savings and how may they be improved?
- What kinds of supplementary data would be useful and what sources could be tapped?
- What are SSA policymakers' priorities with regards to macroeconomic orientation and financial sector development?
- What form should financial sector development take if the goal is to enhance DRM for development? Given past experiences with financial repression, crises, elite capture of

[46] This issue is take up again in the next section
[47] From 1960 to 2000, average total factor productivity growth in Africa declined from a relatively high value of 2 per cent per annum in the 1960s (the same as the world average) to negative values in the 1970–2000 period (Collins and Bosworth, 2003 in UNCTAD, 2007). As a result, annual growth of output per worker in Africa grew by only 0.6 per cent over the period, well below the world average of 2.3 per cent.
[48] Strengths, Weaknesses, Opportunities, Threat matrix

the financial system and the recent experience of financial liberalization, what realistic and strategic options do experts, resource persons, policymakers and researchers see before them?
- How might donors, AfDB and private sector partners contribute to the development of such an agenda?
- What explains high real (lending) interest rates in SSA?
- Are high lending rates constraining credit to the private sector? If so, to what extent and how do we know? What is known about private sector 'credit-demand'?
- Are interest rates constraining (long-term) growth?
- Is inflation-targeting the 'correct' macroeconomic orientation in the SSA context?
- What are/should be the priorities as far as capital market development is concerned? What is the potential for developing regional bond markets as some have suggested?

Making Finance Work for Africa (2007); Finance for All (2008)

Two recent World Bank studies by Honohan and Beck, (2007) and Demirguc-Kunt, Honohan and Beck, (2008) make a significant contributions to the literature on access to credit and financial services in developing countries. The former focuses on SSA while the latter focuses broadly on the importance of finance in the development process.

While it is difficult to summarize these broad studies, two key points emerge from Honohan and Beck (2007):

- Africa needs not only funds, but also a more effective and inclusive means of channeling funds (including financial instruments and services) to where they can be most effective.
- The agenda for financial sector reform and strengthening is a long one. Some reforms require preconditions in the wider economic and political environment, without which they will be ineffective or even counterproductive. A practical strategy would take into account implementation constraints. Therefore the main issue is prioritization.

Growth is the surest way to sustainable poverty reduction and this requires focusing on the more formal parts of the financial system. At the same time however, given the fragmented nature of SSA financial markets and high degree of informalization, efforts are also required to widen low income households' access to the formal financial system, in a way that complements growth objectives.

In addition to low-savings rates four similarities can be generalized across SSA:

- Scale: small size of economies, even smaller financial sectors and sparse populations (low economic density)
- Large degree of informality
- Governance: affects credibility and stability of policy (both revenue mobilization and expenditure/investment)
- High degree of vulnerability to economic and political shocks (both idiosyncratic and systemic; and internal and external)

A major focus of the study is on the role microfinance can play in widening access to financial services and bridging highly fragmented SSA financial services markets. Some of the experiences reviewed in this area include: credit innovations such as credit associated with contract farming, salary loans, progressive housing micro-loans, small enterprise relationship lending, insurance and risk management innovations, deposit and payment innovations such as mobile banking, smart-cards and cell-phone banking and innovations in the area of remittance mobilization.[49]

These[50] provide a good entry point for a systematic inquiry into the role of institutional and instrumental innovations in (a) linking the formal and semiformal/informal economy and (b) increasing overall savings and investment rates. While there is considerable incidental, anecdotal and case-specific information on microfinance and technological innovations, there is a lack of systematic analysis of the potential of such micro-level financial innovations to influence overall savings and investment rates. The research agenda would make a significant contribution by addressing this deficit.

Box.7 Discussion question: Macro-potential of microfinance and technological innovations

- What is the macro-level impact (savings and investment rate) of micro-financial and technological innovations, if any; and what are the projected future effects of these innovations?

It is important to point out that both the World Bank studies reviewed here cover one (albeit crucial) aspect of a broader set of issues and relationships we see comprising DRM, which is ‘improving access to financial services’. We are in agreement with the studies in the sense that improving access to the formal financial system well beyond the present 20 percent levels across Africa is vital if we want to see improvements in aggregates such as capital formation, savings rates and for that matter tax collection, as these measure primarily formal financial sector activities. However ‘access’ cannot be isolated from the wider set of issues[51] and a host of ‘overarching factors’ that affect DRM potential in SSA. We highlight a number of these overarching factors in the next section of this paper and conclude the present discussion of the Bank studies with some of the recommendations that are of interest to the project.

Honohan and Beck (2007) address another key project question from our point of view: What role can donors play in enhancing DRM in Africa? Here their recommendations are fairly straightforward and uncontroversial:

- First of course, donors can bring technology, human and financial expertise (as they are doing already)
- Second, they can exploit their independence from local interest groups to act as agencies of restraint. Ideas such as loan guarantee schemes are increasingly popular[52]

[49] See in particular, Chapter 4, Finance for All
[50] See also Demirguc-Kunt, Honohan and Beck (2008), in particular Chapter 4: Government’s Role in Facilitating Access
[51] Such as those raised in UNCTAD (2007) and to their credit also in World Bank (2007, 2008)
[52] It is important that they do not turn into de facto interest subsidies to projects with high, but unacknowledged, default risk (Honohan and Beck, 2007)

- Donors can forge links between private sector participants, promote farmers' associations, offer technical farm extension advice, and provide basic business development services
- By funding set-up costs they can help avoid the most damaging distortions
- Finally, donors need to look at conditions in their own countries, notably with regard to international remittances[53]

As far as recommendation go, there are a number of overlaps between UNCTAD (2007) and World Bank (2007; 2008). For example, both studies highlight the importance of microfinance. In SSA, the World Bank (2007; 2008) clearly sees some microfinance enterprises growing into banks, and some large banks (including development banks and DFIs) increasingly tapping into microfinance networks to extend their reach to lower income households.[54]

Secondly, an important message of the World Bank studies, following from its acknowledgement of implementation constraints and the need for prioritization, is that SSA policymakers need to look for "shortcuts" where they are available. In this regard, there are at least two relatively low-cost and implementable goals (which are also recommended by UNCTAD). One, given the frequent coexistence of high liquidity and a credit crunch, improving conditions that will help increase the flow of credit to the middle market can be set as the top priority. Boosting credit by strengthening registries and simplifying court procedures could be an important step in easing access to credit and financial services. Two, with the levels of reforms (e.g. banking and financial sector) and innovations (e.g. micro-finance and technological) already taking place, SSA countries need to concentrate on establishing independent supervision. In contrast to UNCTAD (2007) where the "developmental" role of the state as a market maker was highlighted[55]; the World Bank studies (2007; 2008) clearly argue that the role of the state in the financial sector in SSA should be one that facilitates markets rather than participates in it.

Outlining an appropriate role for the state in the five case-study countries whereby the state enhances DRM in a way that fosters sustainable long-term growth, poverty reduction and structural transformation is inevitably a key objective of the project (see Box 3). In agreement with UNCTAD (2007) and others, the state in SSA countries has an important role to play in preparing the groundwork for enhanced DRM, particularly with reference to financial sector institutional development. However, it is hard to ignore the pitfalls that many such forays (DFIs) encountered through the 1980s and 90s across the region, as the World Bank studies recount (2007). How can DFIs and development banks be reconstituted and reconsidered to play a more constructive role in financing long-term

[53] For instance, the European Commission has been successful in driving improved international retail payments technologies and in ensuring lower consumer prices for these payments in the context of the European single currency. These ideas could be extended to remittances toward Africa

[54] The experience of microfinance in South Asia and Latin America, where the scale of the industry is greater, confirms this trend

[55] See also: Ajakaiye (2005), The Role of the State in Financial Sector Development in Sub-Saharan Africa, FONDAD

development objectives is thus a key project question.[56] Beyond DFIs however, the scope and potential of stock markets and private bond markets, and the role of the state in the institutional support structure required to develop the same, is another aspect that requires attention. Pension funds and insurance companies are major players in the process of institution building, and the potential role these could play in implementing DRM strategies should also be considered.

Below we put forward a broad 'framework of inquiry' and discuss a number of overarching factors that affect DRM in SSA. These comprise a wider research agenda within which we see our project playing a small part. The intention is to extend the literature surveyed above and structure debate on these issues towards the finalization of a more 'refined' country-level research protocol. The aim is not to engage in a comprehensive discussion but to raise key points in addition to those already raised. It is anticipated that further issues affecting DRM in SSA will be brought up, both by way of comments received on this paper and at the first project working meeting. **While it is not expected that the project will be able to address each of these issues, we do hope that the discussion will help spark key country level research questions.** The framework can be summarized as follows:

- Savings structure
    - Public sector savings
    - Private-corporate savings
    - Household savings
- Structure of the 'financial economy'
- Structure of the 'real economy'
- Structure of the 'informal economy'
- Series of "overarching" factors affecting DRM in Sub Saharan Africa

IV. A framework of inquiry

The discussion below extends the literature survey and sketches a broader research agenda within which our project forms a small part. Some of the key questions embedded in the discussions are highlighted and could be retained as country-level research questions.

Saving structure

Much of the literature as we have seen places savings at the center of DRM. In general, the high degree of correlation between domestic savings and investment suggests significant external borrowing constraints and also that in developing and emerging economies productive investments are largely domestically financed. Low savings rates, smaller proportion of monetized savings and financial assets (relative to informal and non-financial savings), behavioral characteristics such as 'precautionary' as opposed to investment driven motivation behind savings, together create a structural savings trap in

[56] This issue is taken up again in the next section under the heading 'Financial market institutional development'

poorer countries which invariably affects productivity,[57] investment and ultimately growth.

It is further apparent that the debate about the direction of causality (from growth to savings or visa-versa) is far from concluded. The principal lesson for our purposes however is that high-performing economies (e.g. East Asia, more recently South Asia led by India, and mainland China) pursue dynamic strategies of rapid capital accumulation and growth which enable them to adopt policies suited to their own circumstances and relatively free of the conditionality associated with International Financial Institutions, donors and other external actors.

Intertemporal effects across the three main savings sectors (public, private-corporate and household) have important DRM implications. Therefore it is essential to get a deeper understanding of the differential impact of public, private and household savings in SSA.

- *Public sector: revenue side/expenditure side (inc. capital expenditure)*

On the revenue side, the relative weight of 'domestic' vs. 'external' sources of public sector revenue must be examined. **The relative weights of ODA, tariff revenue, external borrowing and other external sources would need to be decomposed**. Similarly, the relative weight and composition of domestic tax revenues (direct/indirect taxes) would be clarified.[58] **On the expenditure side again external (e.g. interest payments) and domestic facets would need to be decomposed**. Proportion of public sector recurrent vs. capital expenditure[59] would be estimated, with reference to impact on DRM. For instance, fiscal deficits are likely financed by domestic borrowing (from the private sector); estimating the impact on private sector DRM (savings and investment rates, investment climate and macroeconomic effects) would be a suggested starting point.

- *Private-corporate savings: revenue side/expenditure side (inc. investment)*

The literature on private-corporate savings in SSA is scant. **The research agenda could make a valuable contribution by suggesting novel approaches to understanding private-corporate savings characteristics in SS**A and by shedding greater light on the relationship between factors such as macroeconomic policy orientation, fiscal stance, factor productivity, rate of return (and perception of rate of return on investment) and the investment climate.

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[57] When national savings are too low, capital per worker also remains low; in low-income countries capital-per-worker declines further due to expansion of the labour force and depreciation of existing capital stock. By implication it is possible output per worker also declines, and ultimately workers are worse off in income terms (McKinley, 2005)

[58] Two issues of particular interest that should be highlighted are: the impact of tax-incentives (both on revenue and investment promotion) and the capacity to mobilize public revenues (or the 'implementability' of the tax schedule)

[59] Of particular interest is the role of the public sector in financing infrastructure investment and the potential for models such as holding companies, public-private partnerships (PPP) and build-operate-transfers (BOT)

- *Household savings: revenue side/expenditure side (inc. investment)*

Household savings have received greater attention in the extant literature. Low levels of monetization, high non-financial asset holding, low access to formal financial services, precautionary and high liquidity preference are well known characteristics of several individual SSA economies. But equally, it is well known that the financial sector aided by a conducive policy and institutional framework, can play a significant role in mobilizing household savings and enhancing intermediation. The very rapid rise of the financial sector in China and the critical role it has played in the enormous transformation in the savings structure (from public to household sector) is partly a consequence of key policy and institutional initiatives.[60] Similarly, despite low income levels and low access to formal financial services, India has managed to maintain relative high savings rates compared to other developing regions (driven mainly by household savings). Key policy initiatives in the area of rural branching played a significant role in preparing the economy for the growth (led in large part by the financial sector) that the country is presently witnessing.[61] **It is vital therefore to develop a practical understanding of local constraints facing SSA economies, but to do so in a way that highlights opportunities that may exist just beneath the surface**.

Structure of the financial economy

The literature on financial sector development and poverty reduction is vast. More recently however, DRM and financial development has begun to receive particular attention (Mavrotas et. al, 2008).[62] The experience of financial liberalization in much of the developing world shows that transforming the structure of an economy is a complex process that assumes deep understanding of the interaction between the financial sector and the real economy. Evidence suggests financial development can accelerate growth by improving capital allocation. However, in a developing country context 'financial development' must be broadly defined (beyond financial depth) to include improvements in the efficiency of financial sector institutions, including: the banking sector; microfinance; capital markets; legal, regulatory, monitoring and information/signaling institutions – such as credit rating agencies and registries. Deepening and improving the efficiency of the financial sector is becoming a major development issue. Policies that

[60] The share of public and corporate saving in total savings fell from 59.1 per cent in 1978 to 19.6 per cent in 1995 in China, while the share of household saving increased from 12.8 to 51.2 per cent over the same period of time. An important factor driving this change has been the propensity to keep savings in the domestic financial system and confidence in the financial sector (Watanabe, 1998; WESS 2005; Modigliani and Cao, 2004)

[61] Between 1977 and 1990, the Reserve Bank of India mandated that a commercial bank could open a new branch in a location that already had bank branches only if it opened four in locations with no branches. Studies that review the effect of this policy and compare the same across time periods suggests that availability of a bank branch is poverty reducing, even where the branch has been opened only as a result of the policy. Regression results imply that rural branch expansion during the policy period may have accounted for 60 percent of all rural poverty reduction during the period, largely through an increase in nonagricultural activities, which experienced higher returns than in agriculture, and especially through an increase in unregistered or informal manufacturing activities (Demirguc-Kunt, Honohan and Beck, 2008)

[62] Mavrotas G, eds. (2008) 'Domestic Resource Mobilization and Financial Development', UNU-WIDER/Palgrave Macmillan is an important (and very recent contribution – published March, 2008) to the literature. The collection represents the output of UNU-WIDER's research program on 'Financial Sector Development for Growth and Poverty Reduction'

attempt to foster better financial institutions increase the confidence of savers, encourage competition and provide a broader variety of savings instruments – and are thus vital to enhancing savings mobilization and DRM. Mavrotas (2008) highlights, **'while there is extensive literature on financial sector development and savings levels in developing countries, there does not seem to be enough satisfactory work on the above nexus for SSA countries'. Addressing this gap would be a major contribution** of the present research project. In this effort, particular attention will need to be devoted to elucidating the linkages and operational interrelationships between the financial sector and the real and informal economy at the country level in the case-study countries.

Structure of the real economy

Effective DRM strategies will be rooted in and cognizant of the particularities of the structure of the real economy. **This includes presenting a clear picture of the relative size of the agriculture, manufacturing and services sector; and their differential consequences for DRM** (i.e. their interactions with the financial sector, impact of the prevailing tax structure and sectoral savings and investment trends). Similarly the employment structure (across sectors) has implications for fiscal revenues (relative weight of consumption vs. direct payroll, property and capital gains taxes) and for household savings rates. **The DRM impact of level of urbanization (i.e. consolidation of economic activity) needs to be elucidated**. Factor productivity, expected rates of return and the overall investment climate influence savings and investment behavior (Eifert, Gelb, Ramachandran, 2005). It would be useful to get a picture of the interrelationships between these factors at the country level. Furthermore, as seen in the literature review, trade composition (import/export intensity) and promotion (particularly through tax incentives) has DRM implications which need to be understood at the country level.

Structure of the informal economy

The vast majority of economic activity in SSA takes place in the 'informal economy' and by definition this is problematic to account for. However, the issue has received attention in the savings literature (Aryeetey and Udry, 2000) and in broader cross-country comparisons (Schneider, 2004). **Three issues warrant particular attention at the country level: (a) mapping the share of employment/income from the informal economy (to the extent possible), (b) estimating the dynamics of financial market fragmentation and mapping the primary institutions in the informal economy and (c) developing an understanding of the interaction between the informal (and semi-formal) economy and the formal economy (particularly the formal financial sector)**.[63] The existing literature has developed appreciably. Two interesting directions that should be referred to as starting points are institutional analysis of market fragmentation (Nissanke and Aryeetey, 2006) and the recent literature on determinants of informality and 'hiding out' (Dabla-Norris, Gradstein, Inchauste, 2008).

[63] Recent contributions to this literature are interesting and provide a good starting point. See in particular: UNCTAD (2007, p.23-25 for a good discussion of informal and semi-formal economy); Honohan and Beck (2007); (Nissanke and Aryeetey, 2006)

Overarching factors

- *Global growth and investment climate*

The need to strengthen DRM in SSA partly stems from the fact that the international financial architecture has not been able to address the credit constraints faced by less-developed countries[64] and the numerous problems associated with external finance such as aid, direct investment and private capital flows. The paradox that sees ever larger amounts of capital flowing across the globe in search of superior returns, and yet the financing needs of poor countries are largely unmet, is unlikely to be resolved as far as one can predict (Addison, 2005). In recent years, growth in the SSA region has benefited from a benign global investment and inflation climate. The fallout of the ongoing crisis on DRM in SSA is an unexplored (and perhaps premature) issue. However, given the small size and nascent state of development (particularly of the financial sector) in most SSA countries, the external economic climate has a far greater impact (both positive and negative) than in other developing regions (McKinley, 2005). **To what extent and in what ways the global demand (particularly for African commodities), investment, interest-rate and inflationary climate affects DRM in SSA economies is an important question**.

- *Commodity price and terms of trade volatility*

Much in line with the above, it is apparent that Africa's recent high growth performance was driven mainly by robust global demand for African commodities and high commodity prices (UNECA, 2008; Osakwe, 2008). However, sudden changes in external flows present issues of macroeconomic and monetary management and demand improvements in intermediation capacity. Sustained increase in such flows implies that the rest of the economic system will need to adjust – key variables include real interest rates, income, and exchange rates. While the goal of monetary and credit policy is adjustment without inflationary impact, the size and time-lag of adjustment depends on a series of factors (Honohan and Beck, 2007).[65] **It is imperative therefore to take into account the potential for Dutch Disease effects, consequent monetary policy responses and their impact on DRM.** We discuss this issue with particular reference to the ODA-DRM relationship below.

- *Aid dependence and DRM*

Aid, in one form or another, represents a significant proportion of the national economy (and government revenue) of four out of the five project case-study countries: Burundi, Ethiopia, Mozambique and Tanzania. **A key project question is: how can we conceive of a DRM strategy that is also an exit strategy from aid dependence**. As the Paris Declaration recognizes, aid effectiveness requires that partner countries exercise ownership and leadership over their development priorities and strategies. In other words, aid needs to be placed into broader development strategies at the national level (Culpeper,

[64] See: The North-South Institute, "Southern Perspectives on the Reform of the International Development Architecture Phase-II" (various contributions), online at: http://www.nsi-ins.ca/english/research/progress/41.asp

[65] E.g. marginal propensity to import out of increased income, the price elasticity of imports, and the interest sensitivity of money demand

2007). ‘Aid dependence’ has received a significant amount of attention (Azam, Devarajan, O’Connell, 1999; Wangwe, 2007). Equally, the corrosive impact of high aid levels on taxation mobilization and other DRM institutions has also been explored in detail from various academic perspectives (Bird, 2007; Moore, 2007; Moss T and Arvind Subramanian, 2005; Moss T, Pettersson G and van de Walle N, 2006). Focus has shifted from project/program based aid to budget support; however to what extent this represents an evolution as far as moving out of aid dependence is concerned is questionable (World Bank, 2006). There is now a significant ‘fiscal response’ literature on the impact of aid on DRM (particularly in SSA).[66] For instance, Martins (2007) shows in the case of Ethiopia aid flows had a significant ‘displacing effect’ (particularly with regards domestic borrowing). Evidence also suggests aid flows are more volatile than domestic revenue sources (Bulir and Hamann, 2003; 2005 and Khan, 2007). Recent experience in Mozambique, Uganda and Tanzania points to the significant sterilization challenge volatile aid flows present and the resultant impact on DRM via high and volatile interest rates and unpredictable real exchange rates (Aitingi-Ego, 2006; Mohanty and Turner, 2006).[67] High and volatile aid-flows comprise an important overarching DRM constraint and their effect on DRM needs to be elucidated at the country level.

As to whether or not enhanced DRM can contribute towards an exit from aid-dependence, there are at least two examples that point to a positive response to this question. Hang (2007) for instance shows how Vietnam went from a highly aid-dependent country to one that is aid independent, partly on the back of effective aid and donor management led by a relatively strong public sector, and partly on the back of a leading public sector role in infrastructure investment that facilitated the emergence of an export-investment nexus. Similarly, Botswana[68] stands out as an SSA country that has become aid-independent through a mix of enlightened aid management and resource rent mobilization for investment in domestic development (Wangwe, 2007; Leith, 2005).

- *Non-economic shocks*

The frequency of non-economic shocks associated with conflict, famine, and politico-societal collapse as well as with external factors is estimated at one per decade per

[66] See: Martins (2007), p4-8 for a good survey

[67] In Uganda, where donor support of one kind or another accounts for nearly half the government’s expenditure, interruptions in aid flow were very disruptive to the budget and costly to the broader economy. Large aid-funded increases in expenditure equivalent to 8 percent of GDP occurred from 1999–2000 while domestic revenues rose by barely 2 percent of GDP (Aitingi-Ego, 2006). As a result between 1997-98 and 2001-02 Uganda’s fiscal deficit more than doubled to 12.8 percent of GDP. As large deficits were financed via budgetary support, this presented a major sterilization challenge for the Bank of Uganda, as upward pressures on both the real exchange rate and interest rates increased. The Bank of Uganda was forced to resort to aggressive open market operations (1999-July 2001) sending the 91-day yield skyrocketing from 7.1 to 13.8 and the Ex-post real yield from -2.2 to 9.6 percent (Aitingi-Ego, 2006; Mohanty and Turner, 2006).The Ugandan experience is not an isolated example of the major sterilization challenge posed by aid flows. Tanzania (July 1999-April 2000) and Mozambique (July 2000) experienced similar spells of aggressive open market operations in order to contain the inflationary impact of increased aid inflows. The 91-day yield in Tanzania jumped from 7.3 to 13.9 percent (the real yield went from -1.1 to 13.9 percent) and in Mozambique from 12.6 to 22.9 percent (in real terms from 1.8 to 10.4 percent) (Mohanty and Turner, 2006)

[68] Admittedly there are significant ‘non-genralizable’ factors at play (low population, relative political stability and significant resource wealth – diamonds)

country. Coupled with micro or 'idiosyncratic' level risk for individual households near or below the poverty line and for small farms and firms, non-economic shocks can have a disrupting effect on long-term DRM strategies (Honohan and Beck, 2007). How can such factors be taken into consideration is an issue that merits attention in the development of a country-level research agenda.

- *Capital flight*

Capital flight is an issue that has received considerable attention, with reference to developing countries in general and SSA in particular. Estimation and adequate definition of 'capital flight' (such that it is not inflated and confused with broader resident capital outflows) presents statistical and empirical challenges (Schneider, 2003a; 2003b). Recent exploration of capital flight from SSA has helped clarify some of these issues (Salisu, 2005; Ndikumana and Boyce, 2003; UNCTAD 2007, 2008); broadly speaking econometric analysis reveals that external borrowing is positively and significantly related to capital flight, suggesting that to a large extent capital flight is debt-fueled (Ndikumana and Boyce, 2003). Policy recommendations in response to capital flight are thus two-fold: prevention based (from strategies to promote growth, deepen financial markets, improve governance, and reduce debt overhang; to curbs on de facto privatization of public assets, tax-regimes and broader capital controls); and repatriation oriented (primarily tax amnesties and limited taxation on repatriated capital over specified periods). **To what extent is capital flight constraining the DRM base (and in what ways), how should estimates be measured (methodology) and what are the data issues involved, are important questions that would need to be addressed in the discussion surrounding the research protocol.**

- *Macroeconomic policy orientation*

It is widely accepted that macroeconomic stability strongly influences the long-term growth performance of an economy. However, macroeconomic stability should be understood in broader terms entailing more than just preserving price stability and fiscal balances, but also avoiding large swings in economic activity, employment, external accounts and the real exchange rate. As noted, over the recent past SSA economies have fared well on the stabilization front (defined as inflation containment). However, there is now a significant base of theoretical and empirical literature that raises critical questions of the prevailing and dominant "inflation-targeting" orthodoxy, with particular reference to experiences in the developing world.[69] There is an urgent need for developing countries to enhance the space for counter-cyclical policies by improving the institutional framework for macroeconomic policymaking. Vos, Inoue and Sanchez (2007) suggest three steps that are worth mentioning: first, a more appropriate institutional setting for fiscal policy would strike a balance between fiscal prudence and fiscal flexibility in a way that ensures both policy credibility and fiscal sustainability. Setting targets that are independent of short-term growth fluctuations could be effective in establishing an effective counter-cyclical policy stance. Second, a certain degree of discretionary space should be retained; this has been lost in the move to 'rules-based' macroeconomic policy

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[69] See in particular the wide ranging analyses undertaken by the International Development Economics Associates on *'Inflation Targeting: issues and alternatives'*. Various titles and authors, available online: http://www.ideaswebsite.org/feathm/oct2007/ft03_Inflation_Targeting_Index.htm

and the somewhat single-minded pursuit of inflation targeting.[70] At the country level, the impact of macroeconomic orientation on employment and growth objectives would need to be explored. Third, one of the lessons of the East Asian experience is that macroeconomic policies should be well integrated with other areas of economic policymaking and as such ultimately macroeconomic orientation is part of a wider development strategy.

- *Financial market institutional development*

The link between institutional development and DRM (in particular private sector DRM through an efficient financial system) as mentioned, is an issue that is only beginning to receive due attention in the SSA context. The development and deepening of the financial sector in China and India stand out as two examples of the range of possibilities (in a fairly short time-frame) in a developmental context and the significant impact financial development has on smoothing the transition from primarily public to private sector led development. In both cases, the state played a critical role first in establishing and creating financial markets and then populating thin markets and regulating the entry of private actors over time. The rapid transition in China from public to private sector led savings mobilization is nothing short of remarkable, as is the improvement of the efficiency of capital allocation in the domestic economy (Watanabe, 1998; WESS 2005; Modigliani and Cao, 2004; Hasan and Zhou, 2006). Of particular interest in the case of India is the salient truth that though the country still has one of the lowest rates of access to formal financial services rates in the world, it is the financial sector that is in many ways at the helm of the rapid transformation that is presently underway. Over the years Development Finance Institutions (DFIs) have played a crucial role in financial market development in India.[71] With financial liberalization, DFIs moved away from traditional roles (such as principal sources of long-term finance, islands of expertise and signaling agencies) to newer areas (like supporting the development of corporate bond markets, addressing sectoral financing gaps created by deregulation and influencing corporate governance – particularly during the liberalization process). The main lesson of the Indian experience is that where DFIs have been able to transform themselves into 'free market DFIs', **it is clear several developmental tasks remain and DFIs are uniquely placed to perform them** (Varma, 2004; Malshe, 2004).

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[70] For a good contrast see: Ben S. Bernanke, "*A Perspective on Inflation Targeting*", Remarks at the Annual Washington Policy Conference of the National Association of Business Economists, Washington, D.C. March 25, 2003. Bernanke describes the policy framework of Inflation Targeting as "constrained discretion". Constrained discretion attempts to strike a balance between the inflexibility of strict policy rules and the potential lack of discipline and structure inherent in unfettered policymaker discretion. "Constrained" in the sense the central bank must maintain a commitment to keeping inflation and inflation expectations under control and "discretionary" in the sense that the central bank is free to do its best to stabilize output and employment in the face of short-run disturbances, with the appropriate caution born of our imperfect knowledge of the economy and of the effects of policy. Bernanke dispels three myths: that inflation targeting involves mechanical rule-like policymaking, that it ignores output and employment objectives and that it is inconsistent with maintaining financial stability

[71] And one might also consider those in the United States (Fannie Mae and Freddie Mac), Japan (Long Term Credit Bank), Germany (KfW), Brazil (BNDES) and Korea (KDB) among others.

- *Legal and regulatory framework reform; and improvement of the 'informational climate'*

Analyses of DRM in SSA, beginning from a variety of intellectual perspectives seem to converge on the need for legal and regulatory reform and improvement of the informational climate. UNCTAD (2007) argues that the poor endowment of SSA economies in "informational capital" has induced high costs and economic inefficiencies which have stunted financial sector development. Lack of reliable information on the risk profile of borrowers is perhaps the most important factor constraining lending to poorer households and small firms. Given that setting up and maintaining comprehensive borrowers databases may not be in the interest of any individual financial institution, these costs could be at least partly borne by the state (donors and development partners could play an important role here). Similarly, the creation of 'fast-track' courts to speed up settlement of investment disputes could help improve the overall investment climate. The legal and regulatory framework could help prioritize investment in basic infrastructure, remove unnecessary bureaucratic barriers and simplify tax systems by adopting fewer but differential tariff lines for imports of capital or intellectual goods, and fairer taxes by relying more on direct taxation. The main issue for our purposes however is to elucidate at the country-level the ways in which legal, regulatory and 'informational deficits' are constraining DRM and the potential policy responses to the same. Part of the analysis would also need to focus on transparency and accountability of public finances as confidence in the public sector is critical to both successful legal/regulatory reform and improvement of the investment climate.

- *Mobilization of remittances, Diaspora investment and Diaspora bonds*

The key policy issue with respect to remittances is not only how to increase them but also how to encourage use of formal channels and increase allocation to investment rather than consumption. While in balance-of-payment terms remittances are 'external' flows, as both UNCTAD (2007) and World Bank (2007, 2008) show remittance mobilization can and should be considered part of DRM as home-country allegiances and family ties are important motivating factors driving the same. The Diaspora is also uniquely placed as a potential direct investment source; given it has intimate knowledge of the particularities of the home-country and experience overseas. A recent World Bank study estimates that SSA countries can potentially raise \$1 to \$3 billion by reducing the cost of international migrant remittances, \$5 to \$10 billion by issuing Diaspora bonds,[72] and \$17 billion by securitizing future remittances and other future receivables (Ratha D, Mohapatra S, Plaza S, 2008).

- *Mobilization and utilization of resource rents*

Several countries in sub-Saharan Africa are rich in natural resources, including oil and various minerals, but in most countries resource extraction has not yielded the

[72] Diaspora bond is a debt instrument issued by a country—or even by a sub-sovereign body or a private corporation—to raise financing from its overseas Diaspora. This relatively unexploited instrument can raise investments from international migrants for economic development in the home country. The Diaspora from India and Israel have raised \$11bn and \$25bn respectively in recent decades. Philippines has announced that it will sell a Diaspora bond to overseas Filipino workers in 2008 to raise funds for development projects. Ghana has begun marketing the Golden Jubilee Savings Bond to the Ghanaian Diaspora

developmental benefits enjoyed by other resource-rich developing and industrial countries. Indeed, windfalls from oil and other natural resources are regarded “more as a curse than a blessing”, feeding corruption, undermining political and social institutions, generating debt, and fuelling Dutch disease, capital flight and macroeconomic instability (Gelb 1988). Few countries in sub-Saharan Africa besides Botswana have established the economic management and the political and social culture that is required for a more appropriate stewardship of natural resource rents (exceptions include Nigeria’s oil-revenue management strategy, Zambia’s copper-revenue management and Tanzania’s newfound mineral wealth management). Domestic initiatives alone are unlikely to resolve these issues. International cooperation (with resource extracting firms and their home countries) is needed to make headway against the “natural resource trap”, through greater transparency and justice in allocating resource concessions, establishing royalties and determining related government expenditures (Collier 2007).

In the brief concluding section we suggest preliminary ‘research questions’ and hypotheses to be tested at the country-level.

V. Conclusions and Suggested Research Direction

In this paper we have tried to achieve four interrelated objectives: first, we introduced domestic resource mobilization (DRM) as a development finance strategy, and argued there are compelling reasons why DRM is better placed to serve the goals of development finance, compared to alternatives (such as FDI, export earnings, ODA etc.). Second, given DRM is a broad topic, we raised four basic conceptual questions that we think help articulate DRM for the purposes of this project. Third, we situated DRM in the recent international policy dialogue and reviewed the key recent literature on the subject. The emphasis of this part of the paper was on contextualizing DRM in Sub Saharan Africa, providing a backdrop for discussion and setting the foundation for a preliminary framework of inquiry. Fourth, we outlined a framework of inquiry comprising the savings structure, the structure of the financial, real and informal economy and a series of important overarching issues that we think are critical to the potential for DRM as a development finance strategy in SSA. This should help stimulate additional country-level questions.

Inevitably, there will be modifications before the research protocol is finalized (which will include a discussion of methodology and data availability). However, following from the above discussion, we would like to suggest some preliminary research directions. As noted before**, it is anticipated that further issues affecting DRM in SSA will be brought up, both by way of comments received on this paper and at the first project working meeting. While it is not expected that the project will be able to address each of these issues in sufficient detail, we do hope that the discussion will help spark key country level research questions.** We conclude with some basic propositions and questions that could be tested at the country level.

Basic propositions to be tested and preliminary country-level questions

The preceding discussions in this paper have been broad based and have touched on a number of aspects of DRM. In order to obtain a manageable research agenda and one that produces useable results and policy recommendations, we distill our framework into five thematic areas, each comprising a number of testable hypotheses: ‘fundamentals’ (DRM, growth and inflation); ‘policy space and ownership’; ‘fiscal factors’; ‘informal sector factors’; and ‘legal-regulatory, institutional and informational factors affecting the investment climate’. We do acknowledge that some of the propositions may not be applicable in specific country circumstances. Therefore **the following should not be seen as an exhaustive laundry list, rather as a suggested menu from which to pick and refine testable propositions that are relevant to country-level circumstances**. It is expected that the 2day meeting in Entebbe will facilitate this process of refinement towards the finalization of a research protocol for each of the 5 case-study countries.

Fundamentals

Sustained growth, accompanied by structural transformation of the domestic economy plays a fundamental role in poverty reduction. A country level ‘growth diagnostic’ or identification of the binding constraints to growth could provide a good starting point (Hausmann, Rodrik and Velasco, 2005; Filipe and Usui, 2008).

AERC’s “growth project”, in particular O’Connell and Ndulu (2000) and O’Connell (2004) provide a good background to the sources of Africa’s growth. For instance, a striking feature of African investment data is that when measured in constant international prices the figure is much lower than when measured in current national prices. One reason is the comparatively large imported content in African investment. Investment tends to be much more expensive (relative to GDP) in Africa than internationally (O’Connell and Ndulu, 2000). These findings are worth reviewing as a starting point to country-level research.

Some of the findings of O’Connell and Ndulu (2000) that are relevant to DRM are briefly discussed here. One issue is defining ‘structural transformation’. Kenny and Syrquin (1999) developed a method of assessing ‘structural transformation’ along the reference point of a predicted path, which could serve as a useful guide.

A long-standing issue in terms of comparative perspectives on Africa’s growth record has been explaining Africa’s growth shortfall compared to other developing regions. Various reasons are cited: the impact of tax and tax-like policies in generating inefficient aggregate investment (Adam and O’Connell, 1999); a general bias against private sector accumulation (Mkandawire and Soludo, 1999); slow movement of factors of production out of agriculture (Cherney, 1975); geography as an additional factor in African growth, either in undermining the health status of workers or in imposing high transaction costs that discourage market integration (Sachs and Warner, 1997 and Bloom and Sachs, 1998). Other factors include falling capacity utilization, high rates of depreciation of physical capital attributable to poor maintenance of public infrastructure and at times also donor bias against recurrent spending, climate shocks that undermine total factor productivity in agriculture, and civil strife. These factors and the associated literature should be drawn upon given the complex relationship between growth and DRM variables such as public revenue, savings, investment and efficient intermediation. Generally speaking, it is important to estimate how and to what extent African growth performance and DRM levels are converging with the rest of the world.

Hoeffler (1999) employs the augmented Solow model and suggests feedback from growth to investment. These findings can be reviewed for likely endogeneity problems. The augmented Solow model treats technological progress as exogenous and does not model policy effects, on savings or other parameters. How should these effects be modeled in an endogenous growth framework for the purposes of this project? This is a key question for the first research meeting.

Recent years have witnessed interesting advances in the endogenous growth literature, focusing specifically on locating 'domestic savings' within an endogenous growth framework. This strand builds on and significantly differs from the statistical Granger causality tests between growth and the savings rate as in Carroll and Weil (1994) and Attanasio, Picci and Scorcu (2000). The new strategies focus on medium term effect of savings on growth (as opposed to the contemporaneous short-term relationship); models the relationship between lagged savings and growth controlling for initial productivity (as opposed to simple Granger-correlation estimates); and focuses on the differential effect of lagged savings on growth in poor vs. rich countries (Aghion, Comin and Howitt; 2006). Draw on this strand of the endogenous growth literature to ascertain when and to what extent does domestic saving matter for economic growth.

The recent growth literature has returned to some of the 'old ideas' of development economics such as linkages, complementarity, and so called 'superstar effects'. Jones (2008) builds a model with links across sectors, complementary inputs, and highly substitutable consumption. This accounts for much of the aggregate income difference between rich and poor countries. The main findings are that linkages between firms through intermediate goods deliver a multiplier similar to the one associated with capital accumulation in a neoclassical growth model. The share of intermediate goods in revenue is high. Just as a chain is only as strong as its weakest linkages, problems at any point in a production chain can reduce output substantially if inputs enter production in a complementary fashion. High elasticity of substitution associated with final consumption delivers a superstar effect whereby GDP depends disproportionately on the highest levels of productivity in the economy.

These findings provide preliminary support for the working hypothesis that enhanced DRM (as we have defined it above) is critical to poverty reduction and sustained growth. Domestic savings are better placed as an 'investable resource' than available alternatives with the impact on growth operating through productivity (as suggested by Aghion, Comin and Howitt; 2006). Jones (2008) and Aghion et al. (2006) should be referred to as starting points for country level hypotheses testing.

In a recent paper Rodrik and Subramanian (2008) emphasize the fact that developing countries live in a second-best world, which means that they suffer from multiple distortions and constraints. While some nations may be severely constrained by inadequate access to finance, others—and perhaps a majority—are constrained primarily by inadequate investment demand, due either to low social returns or to low private appropriability. Rodrik and Subramanian make the case that some economies can be considered 'savings-constrained' while others are 'investment-constrained'. In the former profitability of investment projects is high relative to current cash flow, leaving firms in need of external finance; while in the latter profitability of investment projects is low relative to cash flow, leaving firms not in need of external finance. The key difference is that financial conditions, and in particular market interest rates, will not be a major determinant of the volume of aggregate investment in the second case. They argue that an improvement in financial intermediation, which raises domestic saving and enhances access of firms to domestic finance in an investment-constrained economy, the direct effect of this on aggregate investment will be nil or small. But an increase in economy-wide saving does have an effect on the real exchange rate, which is the crucial intermediating variable. The key point is that there is a crucial difference between domestic and foreign finance: improvements in the former depreciate the real exchange rate, while improvements in the latter appreciate it. Researchers should be mindful of these findings as they further lend support to an emphasis on DRM.

Testable hypotheses:

- Low DRM levels constrain sustained growth and poverty reduction in Africa
- Greater reliance on non-domestic resources explains convergence-with/divergence-from other developing regions and countries (test and explain, with particular reference to Sub Saharan Africa and South Asia)
- Higher domestic savings can lead to higher growth
- Higher domestic savings are associated with productivity improvements
- Higher domestic savings are associated with higher levels of FDI inflows and equipment imports

Inflation is another fundamental issue, and inflation containment as a macroeconomic objective has a significant impact on policy space for DRM. Building on this line of thinking, O'Connell and Ndulu (2000) show, inflation appears to exert influence on growth in part through investment. Greater macroeconomic uncertainty at high inflation levels, particularly about policy intervention, have important implications in terms of the feasibility of DRM strategies.

Providing a better explanation of the impact of inflation and inflation targeting on the potential for DRM policies on the one hand and on sustainable growth on the other, is a key priority of the proposed research project. Country level policymakers, donors, regional and multilateral institutions need to understand the implications of targeting low-inflation as the main macroeconomic anchor. On the one hand low inflation is essential to reduce the ultimate cost of capital, but on the other hand there are costs associated with achieving low inflation rates which could have the precisely opposite effect on growth (through higher interest rates).

Inflation needs to be modeled and factored into an endogenous growth framework in order to estimate country-level thresholds. There is now a vast literature on this subject and this will be provided as reference. Researchers should approach the issue as a 'cost benefit analysis of maintaining low-inflation' at the country level (what are the real economy costs, if any, in terms of employment, additional future expenditure, policy credibility and other social and developmental indicators). Providing estimates of the trade-offs associated with targeting low-inflation at the country-level could be a valuable contribution of the project.

Policy space and ownership

The rationale for focusing on DRM springs from the quest for sustainable growth and poverty reduction, and the need to create "policy space" to accommodate genuine domestic ownership and country diversity. Reasons for this include the failure of policy conditionality, diversity of opportunities and constraints, and the need for broad-based political and social support (or 'buy-in') for policy options to work.

As we have argued above, the crucial advantage of domestic over external resource mobilization goes beyond the issue of the origin of the resource and is more important on the application front. If it is hypothesized that mobilized external resources (e.g. aid and FDI) do not 'fit' the need of several priority sectors in poor countries, then for this proposition to be accepted there should be some indication domestic resources would play a quantitatively and qualitatively different role. We suggest testing the following hypotheses (and welcome other potential indicators of increased policy-space/ownership).

- Greater reliance on domestic resources facilitates higher investment in sectors neglected by external actors, e.g. agriculture

- Initiatives funded primarily with the help of domestic resources show better result in terms of implementation as compared to those funded largely by external resources

- Investment priorities in higher DRM countries differ substantially from those in low-DRM countries (other things equal)

Fiscal factors

There are two sides to what we have termed 'fiscal factors', the receipt or revenue mobilization side and the expenditure side. The central issues on each side are likely going to be different. On the receipt side, for the majority of countries the main issue is widening the tax-base. The expenditure side however can be further subdivided into recurrent government expenditure and public investment expenditure. On the recurrent expenditure side as well as the public investment side, transparency, accountability and efficiency of expenditure is the crucial issue.

- How reliable is existing country-level fiscal data? What steps can be taken to strengthen data collection?

- What steps can policymakers take to expand the domestic tax base?

- Is there room for rationalization and simplification of the tax structure? Could this contribute to widening the base? What reforms can be suggested?

- Is there scope for institutional reform/development? (For instance creation of an independent 'Revenue Authority' is a model that has seemed to work in a number of countries – e.g. Ghana, Uganda, Zambia, Rwanda).

- What capacity building needs can be identified in the existing tax or revenue authority?

- How effective is coordination between the tax authority, the Ministries of finance, planning and development, the Central Bank and parliament (or PMO or Presidential offices)?

- What is the system of checks and balances as far as revenue mobilization and expenditure transparency and accountability is concerned?

- How can we determine the productivity and efficiency of government recurrent expenditure? (Similarly, investment expenditure, relative to private sector productivity and efficiency)?

- What steps can be taken to improve the transparency and accountability of public expenditure?

Ultimately, SSA countries need to increase fiscal capacity, both in order to wean themselves away from external resources and in order to truly own their national developmental agendas. To do this the fiscal space framework needs to move to one that is development centered from one that is grounded in a purely fiduciary logic.

Informal sector

Majority of the economic activity in a number of African countries takes place in the informal economy. Yet, by definition less is known about these activities than about the formal financial sector (at least in terms of quantitative indicators). There is no reason to believe that a transition to an increased role for the formal sector is inevitable or desirable but the extant literature does stress the importance of inter-linkages between the informal and formal financial economy (UNCTAD, 2007; World Bank, 2007, 2008).

- Map the informal and semi-formal economy (to develop a framework for this, as a starting point see: Steel, Aryeetey, Hettige, Nissanke, 1997; Aryeetey and Senbet, 1999; Aryeetey and Udry, 2000; Aryeetey, 2004; Nissanke and Aryeetey, 2006)

- How does intermediation efficiency in the informal and semiformal financial sector, compare with the formal financial sector?

- How do the informal and formal financial sectors compare in terms of rate of return?

- What are the main linkages between the informal sector and the formal financial sector?

- How can we model the 'macro-level' (i.e. savings/investment in GDP) impact of micro-level initiatives (like microfinance and credit)?

- What are the gender implications of scaling-up micro-initiatives?

- What factors drive informality? For instance, is there evidence of 'hiding-out' (see: Dabla-Norris, Gradstein, Inchauste, 2008)?

Legal-regulatory, institutional and informational factors affecting the investment climate

Key issues to consider here are: the impact of reforms that have recently taken place (e.g. financial sector liberalization); the political economy of tax mobilization; and the political economy of access to formal financial services. On the first point (reforms and liberalization), as much of the literature notes the impact on access to formal financial services has been detrimental in a number of countries, similarly private credit off-take has slowed and persistently high lending-deposit spreads in the commercial banking sector have produced a 'credit crunch' type situation. Furthermore, it has been suggested that reforms have further constrained discretionary policy space, as a result development finance and banking institutions have suffered in particular.

The issues in the area of tax mobilization have been covered in fiscal sector section above, but there may be additional 'informational factors' that might be important to look into such as the potential for incentivizing the entry of firms into the formal sector through tax policies, greater and more effective communication with the commercial sectors.

Finally, there is an urgent need to analyze and build awareness of the 'informational needs' of the private financial sector and investment climate widely. A number of credit-information issues need to be delved into, such as:

- How to improve borrower information? Would a credit-bureau model work? What would this require?

- How can risk management be improved? Can signaling institutions such as credit-rating agencies be developed locally (where they don't already exist)? What steps does this require? What steps can be taken to improve the risk profile of so called 'unbankable' middle market?

- What roles can development finance and development banking institutions play? The recent literature suggests a 'Finance +' approach that envisions a proactive business developmental model for DFIs that is supportive of the domestic private sector.

- What is the scope for public-private partnerships that might stimulate the local private sector? Which sectors are most interesting?

Other important regulatory questions might include:

- Are unnecessarily burdensome regulatory requirements constraining the potential widening and deepening of the financial sector?

- Are regulatory requirements constraining commercial bank lending?

- Does the regulatory structure prevent the use (and consequently deepening) of domestic capital markets?

- What steps can be taken to improve the investment climate to attract 'portfolio' capital flight? What steps are required to repatriate 'illicit' flight capital from offshore havens and what steps do external actors (including development partners) need to take to address this issue?

We would like to emphasize that without doubt there are several other important questions that may need to be addressed at the country-level, emerging from country particularities. The above mentioned should be taken as suggested starting points.

There are a number of important areas that the framework – comprising fundamentals, policy space and ownership, fiscal factors, informal sector factors and legal regulatory and informational issues – does not explicitly cover (but were covered in the earlier sections of this paper). These include the impact of non-economic shocks, remittance mobilization, and harnessing resource rents among others. Some of these issues are receiving attention in ongoing research projects, and it would be useful for the research teams to link-up with these directly. To the extent possible we will aim to develop synergies with complimentary research taking place in other institutions.

DRM is too broad a topic to be satisfactorily addressed by any singular research project in isolation. The objective of the above discussion has been to carve out specific areas that the present project could focus on. We are open to comments and suggestions on further refining the research agenda.

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