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Domestic Resource Mobilization and the Post-2015 Agenda

As the debate on what should replace the Millennium Development Goals (MDGs) heats up, it is time to think about who pays for what. A preliminary analysis shows that taxation features prominently in many post-2015 proposals. Estimates of gaps in financing to meet internationally agreed commitments such as the MDGs have grown over time. Funding gaps are too large to be met by external resources, such as foreign aid, alone. So how about other sources of financing? The most important of these is domestic revenue. Indeed, domestic resource mobilization (DRM) was recognized as a top priority by the Monterrey Consensus on Financing for Development, which accompanied the MDGs (UN 2003).

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MDG Financing and Poverty Reduction Cost Estimates

Estimating financing gaps is problematic because of the assumptions made in the process. That said, gap estimates at least provide a starting point for a conversation. The most recent estimates from the Organisation for Economic Co-operation and Development place the total cost of financing the MDGs at US$120 billion, more than half of which would be needed in 20 low-income countries (Atisophon et al. 2011). The cost of *halving* the number of people living in extreme poverty—below the international poverty benchmark of US$1.25 per day at purchasing power parity—is estimated at US$5 billion, the majority, or US$4.2 billion, of which is needed in sub-Saharan Africa.

What about eliminating global poverty completely? At a higher and arguably more appropriate benchmark of US$2 per day, Homi Kharas and Andrew Rogerson (2012) estimate the cost of eliminating global poverty through direct transfers (i.e., closing the poverty gap ratio) at US$289 billion.

Two Important Shortcomings

Financing gap estimates make two key assumptions. First, that the lack of financing is the “binding” constraint, in that without removing this particular constraint (for example, through more efficient spending or better policies and programs) further progress cannot be made. Second, that additionally mobilized financing can be perfectly transferred to beneficiaries (for instance, those living in extreme poverty can be identified and targeted without cost and without leakage). In the real world these assumptions do not hold, so the right way to interpret gap estimates is as a general reference.

Financing Gap Estimates in Perspective

How do these gap estimates compare with what we know about the current role played by foreign aid? Closing the MDG financing gap of US$120 billion across 99 developing countries would require a tripling of the current level of country programmable aid (or the share of aid that is actually received by countries and over which they have meaningful control). If the international community wished to *eliminate extreme poverty (at the US$2 benchmark) around the world* and was prepared to target *all* country programmable aid in just this one area, it would still end up with a shortfall of about US$200 billion a year. The financing gap in the health sector in sub-Saharan Africa has been estimated at US$19.5 billion, while total country programmable aid spent on health is US$8.7 billion. In other words, even an immediate doubling of donor country programmable aid would not be enough to close the health financing gap.

Can DRM Fill the Gap?

Tax collection has been rising in sub-Saharan Africa and reached a little over 20 per cent of regional gross domestic product (GDP) in 2009. However, the tax to GDP ratio is less than 17 per cent in more than half of (primarily low-income) sub-Saharan African countries. Tax revenue is already over 10 times larger than official development assistance in Africa, and though this varies considerably across countries, it is helpful to remember that even on the world’s poorest continent the majority of development financing is mobilized domestically.

But recent trends show that almost all of the increase in tax mobilization in sub-Saharan Africa has come in the form of taxes and other revenues collected from the natural resources sector. This pattern is causing a split between sub-Saharan African countries. While on the one hand there are those that are mobilizing sufficient tax revenues, mainly driven by the presence of natural resources, there are others that, despite significant tax collection efforts (including donor support), are simply working with too small a tax base. In fact, while oil exporters are the main drivers of the quantitative rise in tax shares across sub-Saharan Africa, non-oil producers, which collect relatively less taxes, have made more progress in broadening their tax bases. Even in best-case scenarios, however, these countries, which include resource-poor, low-income, and some post-conflict and fragile African states, are mobilizing far from enough domestic resources to close MDG financing gaps.

Double-Edged Sword

These countries and their development partners face a double-edged sword. They not only have the weakest DRM capacity and smallest tax bases, but also the weakest aid absorptive capacity. Research shows that when aid reaches between 15 per cent and 45 per cent of a country's GDP, its effectiveness tends to decline, through effects on the exchange rate, inflation, interest rates, and other channels can heighten macroeconomic volatility (Clemens and Radelet 2003). There are several sub-Saharan African countries that fall within this group, including Liberia, Burundi, Mozambique, Malawi, Rwanda, Sierra Leone, and the Democratic Republic of the Congo (DRC). Many of these are fragile states, and as *World Development Report 2011* acknowledged, no low-income fragile state is expected to achieve a single MDG.

Aid is already highly concentrated in fragile states. Around 38 per cent of global aid goes to fragile states, half of which goes to just seven recipients: Afghanistan, the DRC, Ethiopia, Haiti, Pakistan, West Bank and Gaza, and Iraq (OECD 2013). Strikingly, despite this, in recent years domestic revenue has been as much as five times as large as aid even in fragile states (OECD 2011). It is reasonable to expect that most resource-poor fragile states will remain highly dependent on aid for years to come.

DRM Not Just About Closing Financing Gaps

The good news is that if recent trends continue some sub-Saharan African countries will outgrow the need for aid (Fengler 2013). This provides an opportunity to talk about how the aid system and donor approaches need to change, and how much we expect aid to contribute, and where, in the post-2015 development framework. This discussion has not even begun.

As we broach the subject, we need to remember that DRM is not just about closing financing gaps. Nor can it be reduced to quantitative targets like raising mobilization ratios. The North-South Institute's (NSI) research and that of others like the African Development Bank presented at NSI's DRM conference some years back shows that DRM does not exactly collapse when donors cut the purse strings (NSI 2010b). Quite the opposite. For instance, throughout the 1980s and 1990s Uganda and Burundi experienced a marked reduction in aid due to conflict or embargo. However, despite having been highly aid-dependent, both witnessed an increase in tax revenue during periods of reduced donor support. Instability provides incentives for governments to grab what they can when they can. Abstract ratios may well rise, but mobilizing revenue by imposing punitive costs on populations is hardly what anyone is advocating. DRM ultimately ought to be about building better state-citizen compacts than those that exist across most sub-Saharan African countries today.

Donor Roles in Supporting DRM

The international community has been active in scaling up support for DRM efforts in sub-Saharan Africa, as evident in the recent support for the establishment of the African Tax Administration Forum. However, NSI research finds that despite significant reforms to both tax policy and administration, tax mobilization performance has been mixed, limited by structural factors such as low per capita income and very small tax bases (NSI 2010a). Furthermore, revenue foregone due to tax exemptions (not to mention avoidance) is a significant drain on DRM for many countries in the region. This is often the result of lack of coordination between investment promotion objectives and resource mobilization needs. The region has been the most generous among developing regions in terms of granting tax exemptions, particularly in the natural resources sector, with uncertain impacts. Foregone revenues, in addition to large estimates of capital flight from the region, suggest greater DRM potential than is being realized, even in some of the poorest countries (Boyce and Ndikumana 2012).

The share of aid going specifically to building tax administration and collection capacity in sub-Saharan Africa remains fairly low. As a share of technical assistance, aid to public sector financial management capacity building in the region stands at only 2 per cent (AfricanEconomicOutlook.org 2010). There is significant variation in donor support for tax mobilization across the region, with some countries receiving a great deal of attention from a number of regional, bilateral, and multilateral donors, while others are neglected. Donor support for country tax efforts seems to have a short-term impact on tax mobilization performance, which countries often find hard to sustain over time.

Empirically, controlling for the different determinants of taxation, Yiagadeesen Samy and I (2012) find that aid has had no significant impact on taxation generally or in sub-Saharan Africa in particular. When it comes to taxation, what seems to matter most is the structure of an economy, rather than the amount of aid a country receives. Even in regions that have received large amounts of aid over long periods of time, aid does not seem to have a profound effect on taxation. The data clearly show that there are several countries whose dependency on aid has decreased over time (e.g., Botswana, Mauritius, South Korea, Thailand, and Tunisia), and most have seen their taxation capacity grow over time. One area for future research is examining how and why some countries have made this transition while others have found it hard to do so.

As discussions heat up around what should replace the MDGs after 2015, DRM is again taking centre stage. Clearly there remains potential for the international community to do more. The following points are worth keeping in mind:

- Financing gap estimates are at best a general reference for a larger conversation about roles and responsibilities, particularly how the aid system needs to adapt and what we expect aid to contribute in the post-2015 framework.
- Domestically mobilized resources (through taxes and non-tax revenues), not aid, account for the bulk of development financing, even in some of the world's poorest regions.
- DRM trends in sub-Saharan Africa are increasingly divided along natural resource endowment lines.
- The real challenges, not only for aid and development effectiveness but DRM as well, will be increasingly concentrated in a core group of resource-poor, post-conflict, and fragile states; their needs ought to be the main focus of reforms to the international aid architecture.
- DRM, as it relates to a stronger social contract between state and citizen, is an end in itself; reducing it to tax mobilization targets is a distraction already visible in debates on the post-2015 framework.
- Keeping international tax cooperation and combating and reversing capital flight high on the international agenda will remain essential to development efforts.

- Further investing in tax administration and collection capacity-building efforts, including in difficult country contexts, will remain important.
- Investing in informational infrastructure, such as credit reference bureaus and land registries, is key for the development of modern financial systems and capital markets.
- Assisting and encouraging countries to further harness natural resource-related revenues, including comprehensively reviewing tax exemption regimes, is an area that needs a lot more attention.
- Engaging the semi-formal and informal sectors to bring to the fore transparency, accountability, compliance, and other issues is necessary in order to broaden tax bases.

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