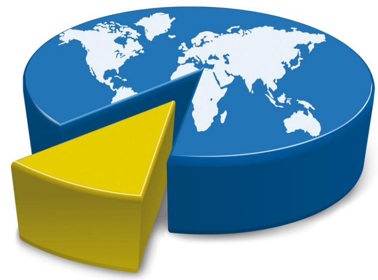
Domestic Resource Mobilization and the Post-2015 Agenda

Aniket Bhushan

As the debate about what replaces the Millennium Development Goals (MDGs) heats up, it is time to think about who pays for what. Our preliminary analysis shows taxation[1] is featuring prominently in 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, or DRM, was recognized as a top priority by the Monterrey Consensus on Financing for Development[2] which accompanied the MDGs. Here, I examine the potential and expectations surrounding tax mobilization as a source of development finance, with a particular emphasis on sub-Saharan Africa.

MDG cost estimates over time

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 OECD[3] place the total MDG financing cost at US$120 billion, more than half of which would be needed in 20 low income countries. The cost of *halving* the number of people living in absolute poverty (below the international poverty benchmark of $1.25 a day at purchasing power parity) is estimated at US$5 billion, the majority, or US$4.2 billion, of which would be needed in sub-Saharan Africa.

What about eliminating global poverty completely? At a higher and arguably more appropriate $2 a day benchmark, Kharas and Rogerson[4] estimate the cost of eliminating $2 a day 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 lack of financing is the 'binding' constraint, in that without removing this particular constraint further progress cannot be made (for example through more efficient spending or better policies and programs). Second, that additionally mobilized financing can be perfectly transferred to beneficiaries; for instance those living in absolute 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.

Placing financing gap estimates in perspective

How do these gap estimates compare with what we know about the role played by foreign aid currently? Closing the financing gap of US$120 billion across 99 developing countries would require a tripling of the current level of country programmable aid[5] (or the share of aid that is actually received by countries and over which they have meaningful control). If the global community wished to eliminate *$2 poverty around the world* and was prepared to target *all* country programmable aid in just this one area, we would still end up with a shortfall of about US$200 billion a year. The financing gaps in the health sector in sub-Saharan Africa has been estimated at US$ 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 funding gap.

Can DRM in Africa fill the gap?

Tax collection has been rising in Africa and reached little over 20% of regional GDP in 2009. However the ratio is less than 17% in more than half of African countries (primarily low income). Tax revenue is already over 10 times larger than ODA in Africa, and though this varies considerably across countries, it is helpful to remember that even on the poorest continent the majority of development financing is mobilized domestically.

But recent trends show that almost all the increase in tax mobilization in Africa has come in the form of taxes and other revenues collected from the natural resources sector.

This pattern is causing a split between African countries. While on the one hand there are those that are mobilizing sufficient tax revenues, mainly driven by the presenc of natural resources, there are others that despite significant tax effort (including donor support) are simply working from too low a base. In fact while oil exporters are the main drivers of the quantitative rise in tax shares across Africa, non-oil producers, which collect relatively less by way of taxes, have made more progress in broadening their tax bases. Even in the best case scenarios however, these countries, which include non-resource rich, low income and some post-conflict and still fragile African states, are far from mobilizing 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 shallowest tax bases, they also have the weakest aid absorptive capacity. Research shows[6] that when aid reaches between 15 and 45% of GDP its effectiveness tends to decline, through effects on the exchange rate, inflation, interest rates and other channels that can heighten macroeconomic volatility. There are several African countries that would fall within this group including, for example, Liberia, Burundi, Mozambique, Malawi, Rwanda, Sierra Leone and the Democratic Republic of Congo. Many of these are fragile states, and as the 2011 World Development Report, *Conflict, Security and Development*[7], acknowledged, no low-income fragile state is expected to achieve a single MDG.

Aid is already highly concentrated among fragile states[8]. Around 38% of global aid goes to fragile states (half of which goes to just 7 recipients: Afghanistan, DR Congo, Ethiopia, Haiti, Pakistan, West Bank & Gaza and Iraq). Strikingly, despite this, in recent years domestic revenue has been as much as five times as large as aid[9] even in fragile states. It is reasonable to expect most non-resource rich fragile states will remain highly aid reliant for years to come.

DRM is not just about closing financing gaps

The good news is that if recent trends continue some African countries will outgrow financial aid[10]. This provides an opportunity to talk about how the aid system and donor approach needs to change, and how much we expect aid to contribute, and where, in the post-2015 agenda. This discussion has not even begun.

As we broach the issue we need to remember that DRM is not just about closing financing gaps. Neither can it be reduced to quantitative targets like raising mobilization ratios. Our own research and that of others like the African Development Bank presented at our DRM conferences[11] some years back, shows that when donors cut off the purse strings DRM doesn't exactly collapse. Quite the opposite. Throughout the 1980s and 1990s, Uganda and Burundi for instance 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 leadership to grab what they can when they can. Abstract ratios may well rise, but mobilizing revenue by imposing punitive costs on the population is hardly what anyone is advocating. DRM ultimately ought to be about building a better state-citizen compact than exists across most sub-Saharan countries today.

Donor role in supporting DRM

The international community has been active in scaling up support of DRM efforts in Africa, most recently as evident in the support for the establishment of the African Tax Administration Forum (ATAF[12]). However research conducted by The North-South Institute[13] finds that despite significant reforms to both tax policy and administration, tax mobilization performance has been mixed, limited by structural factors including low per capita income and very shallow tax bases. Furthermore, revenue foregone due to tax exemptions[14] (not to mention avoidance[15]) 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[16], suggest greater DRM potential even in some of the poorest countries than is being realized.

The share of aid going specifically to building tax capacity in Africa remains fairly low. According to the African Economic Outlook[17], as a share of technical assistance, aid to public-sector financial management capacity building stands at only 2% in Africa. 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 find hard to sustain over time.

Empirically, controlling for the different determinants of taxation, NSI Distinguished Research Associate and Carleton academic Yiagadeesen Samy and I find that aid has had no significant impact on taxation[18] generally or in sub-Saharan Africa particularly. When it comes to taxation what seems to matter most is the structure of the economy, rather than the amount of aid a country receives. Even in regions that have received large amounts of aid over long periods, aid does not seem to have a profound effect on taxation. The data clearly shows that there are several countries whose dependency on aid has decreased over time (for example, Botswana, Mauritius, South Korea, Thailand and Tunisia), and most have seen their taxation capacity grow over time. An area for future research would be to examine how and why some countries have made this transition while others find it hard to do so.

As discussions heat up around what should replace the MDGs beyond 2015, DRM is again taking center 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 agenda
- Domestically mobilized resources (through taxes and non-tax revenues), not aid, accounts for the bulk of development financing, even in some of the poorest regions
- Revenue mobilization trends in Africa are increasingly divided along natural resource endowments lines
- The real challenges, not only for aid and development effectiveness but DRM as well, will be increasingly concentrated in a core group of non-resource rich, fragile and post-conflict states; their needs ought to be the main preoccupation of reforms to the 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 post-2015 debates
- Keeping international tax cooperation and development high on the global agenda, combating and reversing capital flight will remain essential
- Further investing in tax capacity building efforts, including in difficult country contexts, will remain important
- Investing in the informational infrastructure – ranging from credit reference bureaus to land registries – is essential for the development of a modern financial system and capital markets
- Assisting and encouraging countries to further harness natural resources related revenues, including comprehensively reviewing tax exemptions 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

Notes:

1. Canadian International Development Platform, Welcome to The North-South Institute's "Tracking Post-2015" tool, a platform for analyzing proposals on the post-2015 framework. Retrieved 13-03-25 http://public.tableausoftware.com/shared/SZQ3DDKRH?:display_count=yes
2. United Nations, 2002, Monterrey Consensus of the International Conference on Financing for Development, International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002, www.un.org/esa/ffd/monterrey/Monterrey Consensus.pdf
3. Atisophon, Bueren, De Paepe, Garroway and Stijns, 2011, Revisiting MDG cost estimates from a Domestic Resource Mobilisation Perspective, OECD Development Centre, Working Paper No. 306, www.oecd.org/dev/49301301.pdf
4. Kharas and Rogerson, 2012, Horizon 2025: creative destruction in the aid industry, Overseas Development Institute, retrieved 13-03-25, www.odi.org.uk/publications/6687-creative-destruction-aid-industry-development-kharas-rogerson
5. OECD, Country Programmable Aid (CPA), retrieved 13-03-25, www.oecd.org/development/aideffectiveness/cpa.htm
6. Centre for Global Development, www.cgdev.org/doc/books/Challenging FA/07--CH. 7--125-144.pdf
7. The World Bank, 2011, Conflict, Security and Development, World Development Report 20122, http://siteresources.worldbank.org/INTWDRS/Resources/WDR2011_Full_Text.pdf
8. OECD, Data from Fragile States 2013: Resource flows and trends in a shifting world (2/5), retrieved 13-03-25, www.oecd.org/dac/conflictandfragility/
9. OECD, Data from Ensuring Fragile States Are Not Left Behind 2011 (3/8), retrieved 13-03-25, www.oecd.org/dac/conflictandfragility/
10. Fengler, 2013, Has Africa outgrown Aid? Africa can...outgrow poverty, retrieved 13-03-25, http://blogs.worldbank.org/africacan/has-africa-outgrown-aid
11. The North-South Institute, 2009, Political Economy Dynamics Underpinning DRM, Lessons from the EAC and South Africa, Wilton Park 27-30 April, 2009 www.nsi-ins.ca/content/download/Sennoga.pdf
12. The African Tax Administration Forum, www.ataftax.net/
13. The North-South Institute, 2010, Domestic Resource Mobilization in Africa: An Overview www.nsi-ins.ca/content/download/DRM_Synthesis_V5.pdf
14. Gaddis, et al. 2013, Is Tanzania Raising Enough Tax Revenue? Africa can...outgrow poverty, retrieved 13-03-25, http://blogs.worldbank.org/africacan/is-tanzania-raising-enough-tax-revenue
15. Jordan, 2013, Western tax avoidance hinders African development, The Guardian, retrieved 13-03-25, www.guardian.co.uk/commentisfree/2013/feb/11/western-tax-avoidance-restricting-african-development
16. Boyce and Ndikumana, 2012, Capital Flight from Sub-Saharan African Countries: Updated Estimates, 1970 – 2010, Political Economy Research Institute report, www.peri.umass.edu/fileadmin/pdf/ADP/SSAfrica_capitalflight_Oct23_2012.pdf
17. African Economic Outlook, 2010, Public Resource Mobilisation & Aid, http://tinyurl.com/bo8d8l2
18. Bhushan and Samy, 2012, Aid and Taxation: Is Sub-Saharan Africa Different? The North South Institute, www.nsi-ins.ca/publications/aid-and-taxation-is-sub-saharan-africa-different/

Author

Aniket Bhushan is Senior Researcher at the North-South Institute and leads the Canadian International Development Platform. www.cidpnsi.ca