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Enhancing the Role of Domestic Financial Resources in Africa's Development

A Policy Handbook

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Introduction

Project background

Filling Africa's development resource gap has long been a preoccupation of the development community, and efforts to attain this have been intensified since the turn of the century. This is evidenced by the United Nations Financing for Development Conference held in Monterrey in 2002 and other high profile summits on African development since then. Attention has largely been focused on external sources of development finance, such as debt relief, increased aid and its effective use and foreign direct investment (FDI). Despite all good intentions, the heavily indebted poor country (HIPC) debt relief programme has fallen short of its own cardinal principle of additionality. And while aid flows have increased from the trough of the late 1990s, questions remain about their quality, efficacy, predictability and the ability of donors to meet set targets. Similarly, doubts have been expressed about the quality of FDI flowing into Africa, its impact on development in terms of job creation, diffusion of technology, forward and backward linkages in the host economy and its concentration in the extractive sector.

The current economic crisis highlights the problems associated with overreliance on external financial resources and makes domestic resource mobilization even more relevant. Indeed, there is fear that aid to Africa will decline as donors struggle to contain the social and economic consequences of the crisis on their own citizens. Given the colossal amounts that have been committed to bail out Western economies, aid to Africa could become a second order priority. Moreover, before the crisis, improvements in governance and macroeconomic policies in Africa had attracted a diversified range of external flows, including FDI, portfolio investments, remittances and trade credit, which contributed to the relatively high rates of growth recorded over the last ten years. The current climate of economic uncertainty threatens these positive developments as sentiment towards investment changes. Foreign direct investment in non-traditional sectors, particularly outside mining, will most likely decline as investors are nervous about the direction world economies are taking. Portfolio investments have already declined from about $16 billion in 2007 to $6 billion by November 2008 as a result of the tightening of global liquidity. The same trend has been observed with respect to remittances given that most Western economies hosting large diasporas are in recession. In addition, the prices of key commodities such as coffee, cocoa, copper and oil have declined substantially, reducing Africa's export earnings.

The decline in external financial flows illustrates that the issue of how Africa's development should be financed is far from settled. External debt has been used in many countries as the main source of development financing but several observers have cautioned against a possible re-accumulation of unsustainable levels of external debt in Africa. It is clear, therefore, that African countries cannot count solely on external financial resources to meet their development needs. Domestic resource mobilization and efficient investment in areas that promote the structural transformation and sustainable development of African countries are of utmost importance.

Surprisingly, apart from the limited reforms to liberalize the financial sector and some attempts to increase public revenue through the introduction of consumption taxes such as VAT (value added tax), many African countries have not considered domestic resource mobilization as an important vehicle for increasing development finance. This handbook is expected to help fill this lacuna. It has been prepared as part of the United Nations Conference on Trade and Development (UNCTAD) secretariat's project on "Developing local capacities for the identification of growth opportunities through resource mobilization", financed by the United Nations Development Account (Fifth Tranche). The objective of the project is to strengthen the capacity of African countries to identify and utilize efficiently non-debt-creating domestic resources in order to meet the Millennium Development Goals (MDGs), especially the first goal of halving poverty rates by 2015.

Activities of the project started with an Expert Group Meeting in February 2007 in Geneva. Representatives of finance ministries from several African countries, together with international experts in the field of development finance and several country consultants, contributed actively to the discussion of the main issues involved in domestic resource mobilization and use, on the basis of a project concept paper prepared by an international consultant.

Following the Expert Group Meeting, consultants from Benin, Burundi, Mauritania, Mauritius, Namibia and Sierra Leone were recruited to draft studies on the history and prospects of domestic resource mobilization and efficient use in their respective countries. These studies (and an overview prepared by the UNCTAD secretariat) were presented and discussed at a first regional seminar held from 25 to 27 July 2007 in Cotonou, Benin.

At the second regional seminar (Mauritius, 28–30 November 2007), representatives from three non-case study countries, Ethiopia, Kenya and Zambia, were added to the original group of the other six countries. They presented briefings on the major issues in domestic financial resource mobilization in their countries in addition to the discussion of the revised case studies and the overview. Two new papers were presented by an international consultant and the secretariat on, respectively, fiscal policies with an emphasis on the efficiency of government expenditure, and capital flight from Africa. The secretariat also presented a draft *Policy Handbook on Enhancing the Role of Domestic Resources in Development* derived from the case studies, the discussions at the first seminar and its research for the *Economic Development in Africa 2007 Report*.

The draft handbook was intensively discussed and many seminar participants provided their insightful views based on their professional experiences. The draft was further revised and additional case studies on domestic resource mobilization were commissioned from Kenya and Zambia. In April 2008, the revised draft handbook integrating this new information was presented and discussed at stakeholder workshops in Burundi and Zambia.

The country studies, the discussions held during the Expert Group Meeting, the first and second regional seminars and the stakeholder workshops constitute the main raw material on which this handbook is based. Therefore, rather than being an analytical document, this handbook seeks to distil these insights into a practical policy-oriented guide. The main objective is to highlight some largely neglected opportunities for increasing the types and levels of financial resources for the continent's development through an improvement in domestic financial resource mobilization and efficient use.

It is not the objective of this handbook to fully develop all its policy proposals. The reason is simply that doing so would require a much bigger document and this would go against its aims of practicality and simplicity. Moreover, many of the suggestions contained in this document apply differently to different countries. In this light, the handbook provides starting points and directions from which policymakers interested in specific issues covered by the document can carry out further investigations.

Why should African countries look to domestic resources to meet their development financial needs?

There is currently a financial resource gap in most African countries.

Sub-Saharan Africa has experienced relatively strong growth rates in the past few years; GDP per capita has now been increasing for eight consecutive years (3.4 per cent growth in 2007), although from very low initial levels. This represents a welcome break from two decades of economic stagnation in the region. Nonetheless, the current rates of growth are insufficient for the region to meet the Millennium Development Goals. Indeed, it has been estimated that, if African countries are to meet the first MDG of halving poverty by 2015, they need to reach annual growth rates of around 7 per cent for a relatively long period of time, which is more than the average growth rate of about 6 per cent reached in 2007.

Additionally, much of the recent strong performance in Africa has been due to the high prices attained by commodities in the world market. This performance is narrowly based with little impact on employment creation and it remains highly vulnerable to external shocks. Commodity price drops in 2008 and the current economic crisis may signal the beginning of the end of Africa's high rates of growth.

To sustain or even increase the current rates of growth, African countries need to increase their investment rates. Indeed, the rate of fixed capital formation in sub-Saharan Africa was only 19.8 per cent in 2006 (see table 1), which is almost half the rate of the East Asia and Pacific region (37.2 per cent) and far below the 34 per cent rate that the United Nations Economic Commission for Africa (UNECA) estimates would enable these countries to meet the first MDG of halving poverty by 2015. The low rates of investment are due in part to the difficulties of the investment climate in many African countries despite some recent improvements. They also reflect the low levels of domestic savings, 20.1 per cent of GDP in 2006, the lowest of any region.

Increasing the resources that are available to finance investments and improving the productivity of these investments are therefore essential for African countries to achieve faster, and possibly more inclusive, growth.

Table 1
Gross domestic saving and gross fixed capital formation in 2006

	Gross domestic saving as a percentage of GDP	Gross fixed capital formation as a percentage of GDP
East Asia and Pacific	45.6	37.2
Europe and Central Asia	23.1	21.1
Latin America and Caribbean	22.8	19.7
Middle East and North Africa[a]	28.7	23.1
South Asia	27.5	28.0
Sub-Saharan Africa	20.1	19.8

Source: World Bank, *World Development Indicators*, online dataset.

a Data for the Middle East and North Africa relate to 2005.

Domestic financial resources are best suited to closing the resource gap.

Although external assistance will continue to play an essential role in Africa's development, a focus on domestic resources to meet the medium- to long-term development needs of African countries is justified for a number of reasons.

Firstly, enhancing the role of domestic resources in the development of African countries reduces their dependence on external capital inflows such as official development assistance (ODA), foreign borrowing and foreign direct investment. By reducing the dependence on these inflows and their associated conditionalities, domestic resources allow African countries more policy space and hence more control of their development process. As a result, African countries are more able to pursue truly nationally-owned development strategies that respond to their genuine priorities.

Secondly, more reliance on domestic resources, particularly public revenue, can lead to a better system of governance. Mobilizing domestic public revenue involves an implicit contract between the state and the households and firms that generate them. This requires improved cooperation between the state and these domestic entities. If, for example, the state invests its revenue in public and social services that benefit the communities where these resources are generated, there is evidence that tax evasion would be reduced. In fact, survey evidence in some African countries reveals that taxpayers would even be willing to pay more taxes if they perceived that these resources were efficiently used. Hence the efficient use of public resources and its accompanying improvement in tax compliance could help foster good practices that are an integral part of a system of good governance. In fact, the efficiency with which a state mobilizes, allocates and spends public resources is an attribute of a well functioning state.

Thirdly, domestic resources are considerably more stable than external capital inflows. Even though ODA and FDI to Africa have increased in recent years, these inflows remain volatile. In Africa, UNCTAD has estimated that ODA is up to four times more volatile than domestic tax revenue. Also, external resources are heavily concentrated both geographically and sectorally. In Africa, FDI tends to be heavily concentrated in the extractive mineral sector, particularly the oil and gas industry, which tends to be highly capital-intensive. These investments do not generate much employment and have few linkages with the rest of the domestic economy.

Of course, increasing domestic financial resources will not by itself solve all the problems faced by African countries, particularly in view of the limitations of African institutions and human resources to help achieve development objectives. However, in the medium to long term, the ability of African countries to finance an increasing share of their development needs from domestic sources would give them much needed flexibility in the formulation and implementation of policies that address their economic, social and other developmental challenges. The multiplicity of the challenges facing Africa inevitably calls for an appropriate "policy mix" or "diversity of policies" tailored to the specific situation of each country, rather than a "one size fits all" approach. In this context, Africa's need for more policy space cannot be overemphasized. African countries need to design and implement policies that make optimal use of available resources in a way that leads to a virtuous circle of accumulation, investment, growth and poverty reduction.

Chapter I

Domestic Financial Resources in Africa

A. Boosting private savings in the formal financial sector

Savings rates in sub-Saharan Africa are the lowest of any region. In 2006, domestic savings represented 20.1 per cent of GDP in the region while they were worth 23.0 per cent in Latin America and the Caribbean, and 45.6 per cent in East Asia and the Pacific. There are several reasons for this. Countries in the region are characterized by low incomes, high dependency ratios and, until recently, low rates of growth.

Officially recorded rates of savings do not however measure the full extent of potential resources that could be mobilized in African countries. Indeed, savings in the formal financial sector represent only a small fraction of the total. Most savings are held either in non-financial assets or in the informal financial sector. Indeed,

Table 2
Savings, incomes, growth and dependency ratios, 1995–2006 averages

	Gross domestic savings/ GDP (%)	GDP per capita ($)	GDP annual growth rate (%)	Dependency ratio[a]
East Asia and the Pacific	39.0	1 033.1	7.8	0.5
Europe and Central Asia	22.1	2 062.0	4.1	0.5
Latin America and Caribbean	19.9	3 905.1	2.8	0.6
Middle East and North Africa	24.3	1 637.0	4.2	0.7
South Asia	23.0	466.6	6.3	0.7
Sub-Saharan Africa	17.6	521.8	4.9	0.9

Source: World Bank (2008) *World Development Indicators*.

a Dependency ratio = (population over 65 + population under 15) / working age population.

studies suggest that non-financial assets represent up to 80 per cent of all household assets in some rural areas. These modes of saving outside the formal financial system are much less amenable to accurate capture by national statistics.

Despite the structural impediments to higher savings mentioned above, putting in place policies that induce a larger proportion of savings towards the formal financial sector would increase the amount of resources available for intermediation towards productive investment.

B. Many countries can benefit from improved public revenue collection

Taxes are an important domestic resource and have a role to play that is distinct and complementary to the role of private savings. Most importantly, taxes and other government revenues should fund the provision of essential public goods such as education and health services, infrastructure development and maintenance, law and order, and efficient public administration. However, most African countries collect only a fraction of potentially available taxes. While some countries such as Botswana and the Congo have high tax revenue to GDP ratios (respectively 39 per cent and 31 per cent in 2004), there are many African countries whose performance is closer to Chad's tax ratio of 5 per cent of GDP. Hence, the efficiency and effectiveness of the tax system can be considerably improved in many countries through tax policy innovations. In Ghana for example, tax reforms helped to double tax revenue from 11 per cent of GDP in 1990 to 22 per cent in 2004.

Ghana's successful reforms revolved around the introduction of VAT and the institution of the revenue authority model. The main advantage of this model, which has been adopted by other African countries including Kenya, Malawi, Rwanda, the United Republic of Tanzania, Uganda and Zambia, is that it creates a semi-autonomous entity that is run on the basis of business principles rather than a politicized institution. This, in general, reduces political interference and corruption. Such an institution also generally provides higher incentives to its employees than the civil service, which helps to attract and retain high quality staff. A revenue authority is more efficient as it integrates into one entity tax functions that are otherwise scattered in different departments within the Ministry of Finance. Finally, the revenue authority model is attractive because locating all tax administration functions in one autonomous entity facilitates much needed reforms to achieve higher efficiency in tax collection.

Improving revenue collection is not only about increasing the amounts collected. In fact, increasing the rates or number of taxes can have an adverse effect on the total amount of domestic resources devoted to productive investment in an economy. If the tax system is too burdensome for individuals or firms, this encourages tax evasion and acts as a disincentive for firms to enter the formal sector.

Rather than being regarded purely as a means of raising revenue for the state, taxation should be seen as an embodiment of the relation between the state and society. Improving the tax system, making it fairer and more administratively convenient, can therefore help reinforce state legitimacy and capacity and nurture a taxpaying culture.

C. Remittances represent an important inflow of resources to many African countries yet their development potential remains largely untapped

Remittances from migrant workers have increased considerably in recent years and now constitute the second largest external capital inflow to developing countries. Global remittance flows to developing countries were worth $193 billion in 2005 while FDI flows totalled $281 billion. In Africa, remittances are increasingly being seen as important resources for development even though recorded inflows remain smaller than ODA or FDI. Estimates suggest that remittances to Africa were around $40 billion in 2006, mostly to North African countries. Recorded remittance transfers to sub-Saharan Africa amounted to $9.25 billion in 2006, though actual transfers are estimated to be at least twice as large. Indeed, it is estimated that over half of remittance transfers to sub-Saharan Africa are unrecorded.

Estimates suggest that in sub-Saharan Africa actual remittances represent about 5 per cent of GDP, or 27 per cent of export receipts. In some individual countries, however, they make up more than a third of GDP (Cape Verde and Eritrea) and, in others, one fifth of GDP (Lesotho and Liberia). Additionally, remittances are a more stable resource inflow than either ODA or FDI. They have no associated conditionalities and they reach their beneficiaries directly thereby reducing poverty, notably by allowing recipient households to pay for school fees or health services, which boosts aggregate demand and production.

The potential development impact of remittances is not fully realized. The reasons include high transaction costs both in the official and in the informal channels and the lack of appropriate financial services for transfers in recipient countries. Notably, the costs of transfers have remained very high because of regulatory restrictions and prevalence of monopolies (banks and few money transfer operators) enjoying exclusivity deals with banks. As a result, remittances are being transferred largely outside of the formal financial system.

D. Capital flight continues to deprive African countries of much needed resources for development

Capital flight essentially involves the transfer of domestic or national savings to foreign accounts and as such entails a loss of resources that could otherwise be invested domestically. Broadly defined, capital flight covers all investments in external assets by the private sector, whether legal or illegal. A narrower definition would be all investments in external assets by the private sector that are not reported to the authorities and, therefore, not recorded in balance of payments statistics. The latter definition focuses more on the proceeds of corruption and money gained from other illicit activities.

Capital flight is mainly induced by the risk of holding assets domestically, the most common determinants of this risk being political instability, corruption and price distortions, which constitute a tax on assets held domestically. As these risks impact negatively on returns on domestically held assets, they influence portfolio choice in favour of foreign assets that attract higher returns or carry lower risks. External borrowing has also been found to be highly associated with capital flight. This is in part due to borrowing being seen as a signal for inefficient macroeconomic management that harms domestic investment. Additionally, foreign loans are sometimes appropriated by the elite and transferred to their private bank accounts abroad in the form of capital flight.

Though estimations vary widely, it is clear that African countries have lost a considerable amount of resources to capital flight. It has been estimated for example that Africa's cumulated stock of capital flight for the period 1970–2004 was $607 billion, representing almost three times the region's external debt. The extent of the problem varies from country to country. In Sierra Leone, accumulated capital flight was worth 425 per cent of the country's GDP in 2004. The comparable figures were 344 per cent in both the Congo and Zimbabwe and 312 per cent in Burundi. However, in Benin, Niger, Senegal and Togo, capital flight is negative, implying that these countries experienced higher capital inflows than outflows.

Given the relationship between capital flight and external debt, reducing the latter would likely lower the incentive to hold assets abroad. Similarly, reducing the risk associated with holding domestic assets (i.e., greater political stability, reducing corruption and maintaining macroeconomic stability) is expected to reduce capital flight. However, these would only stem the flow of assets that are legally transferred abroad. For those illegal assets held abroad, legal mechanisms might be necessary to impound and forcibly repatriate them. The right of countries to repatriate assets illegally transferred out of the country was enshrined in the United Nations Convention Against Corruption adopted by the United Nations General Assembly on 31 October 2003.

Stemming capital flight and encouraging the repatriation of capital held abroad can have a very significant impact on the level of resources available for productive investment in many African countries.

E. There are, however, several obstacles that need to be tackled for these resources to play a greater role in the development process

The most important issue to address in order to enhance the role of domestic resources in development is tackling the high level of uncertainty that prevails in African economies. This uncertainty is mainly due to the economic and political instability that has characterized many African countries until recent times. Despite the fact that the situation has generally improved in the past few years, there remains mistrust amongst users and providers of financial services as well as between economic agents and the state. Economic and political stability must be further improved and sustained to create an environment that can support a development strategy based on the use of national resources. Indeed, financial transactions such as contractual savings or investment depend on people being able to trust that conditions, rules and regulations will not show extreme variation over a relatively long period of time. Instability not only weakens the financial sector, but also encourages capital flight and tax evasion. In Burundi and Sierra Leone for example, the consequences of years of instability and war are plainly visible in both their very low rates of savings as well as the very high level of capital flight.

There are tasks that the state is best placed to perform and that are essential to a development strategy based on domestic resources. These include effective and fair tax collection, the provision of essential public goods and the guarantee of safety and security, including respect for property and the rule of law.

In many African countries, however, the state is not fulfilling its role adequately. There is therefore a need not only for change in policies, but also for a more profound change in the way the state views and performs its developmental role.

This handbook seeks to help African countries improve their domestic resource mobilization strategies and use more efficiently these domestic resources for development. To do so, it outlines a number of practical policy recommendations that the state can implement to reach this goal. The policies described in this handbook should not be seen in isolation: any one policy taken on its own is unlikely to have a notable impact. Rather, these policies should be seen as a package of measures that will contribute to the creation of such an enabling environment.

Enhancing domestic resource mobilization will further the capacity of African countries to pursue nationally owned development strategies by increasing the amount of resources available for development and concomitantly reducing overdependence on development partners. Strengthening institutions as part of an overall development strategy will also ensure coherence in policy formulation and implementation that will facilitate the efficient management of development resources. It is this dynamic interaction between improved capacity and more efficient resource management that can help to put African countries on the path towards higher growth and faster poverty reduction.

Chapter II

Financial Sector Reform

A. Characteristics of the financial sector in Africa

A well functioning financial sector is a precondition for any development strategy based on the enhanced mobilization and productive use of domestic resources. In African countries, however, the financial sector tends to be severely underperforming in both these functions.

The financial sector in most African countries is shallow and fragmented. A small, mainly urban, formal financial sector primarily dedicates itself to meeting the financial needs of the government, large firms and a small number of urban-based elites. As a result, the lending portfolios of financial institutions are often very poorly diversified. In Sierra Leone for example, government borrowing accounts for 80 per cent of domestic credit. At the other end of the spectrum, a large informal financial sector provides some financial services to the poor and rural-based population, as well as some small enterprises. This fragmentation arises in large part because of the way financial service providers deal with risk.

Faced with high systemic risks and little borrower information, informal financial agents rely on small and repeated transactions within a community setting. At the other end of the market, formal financial institutions, which often have poor risk management capabilities, hold levels of liquidity far above what is required by prudential regulation and lend mainly to large corporations and well known borrowers. It should be acknowledged, however, that the resistance of formal financial institutions to lend could be justified by the high degree of risk prevailing in African markets. As discussed in chapter IV, even when financial resources are available, they are not fully channelled to productive investment due to the lack of low risk, profitable investment projects.

This situation is not optimal, as the resources mobilized in the informal financial sector are not made available for further investment. This is because only few informal financial institutions provide both deposit and credit facilities and those that do usually award credit on the basis of membership rather than profitability. Additionally, deposit collectors in the informal sector do not pay interest on deposits. In fact they usually keep part of the deposit as fees, and therefore do not have to turn a profit on investment. In the formal financial sector, the investment record is poor due to adverse loan selection based on risk aversion rather than expected profitability.

Furthermore, there is often a gap in financial services for small and medium-size enterprises (SMEs). The main reason is that their financial needs are too large or too complex for informal economic agents to handle but the lack of sufficient collateral or credit history implies that SMEs cannot access formal financial services either. Indeed, studies show that in many African countries, firms of up to 25 workers routinely name access to credit as a major concern and many of these firms either have had their requests for credit turned down by banks or have come to consider that it would be a waste of time to even make such a request. This gap is at present only very partially covered by a semi-formal financial sector whose institutions are registered but not subject to full prudential regulation; these are mainly microfinance institutions.

Cost also plays a role in explaining the segmentation of the financial services market in many African countries. Poor infrastructure coverage and low population densities over large land areas have until recently made the provision of formal financial services outside main cities very expensive. As a result, formal financial service provision is poor outside urban areas, although this is beginning to change in a few countries with the advent of telephone banking and other initiatives using new communications technology (see policy 9 below). Additionally, the measures to encourage branch banking that existed in many countries have largely been rescinded by the liberalization of the financial sector in the past decades. The cost of providing financial services in rural areas is much lower for informal and semi-formal institutions that operate on a smaller scale and do not depend on modern communication means. It has been estimated that administrative costs associated with loans of formal sector banks in rural areas are up to ten times higher than costs incurred by microfinance institutions.

Coverage of the financial sector must be improved as its current fragmentation and poor geographical coverage entail high costs and create inefficiencies. Increased synergies should be created between the formal, semi-formal and informal actors of the financial sector in order to capitalize on their respective comparative advantages and make up for their weaknesses and inefficiencies.

Informal agents are strong in terms of access and information. They also play the greatest role in the mobilization of savings amongst rural and poorer households as well as small businesses. Individually, however, they are often severely limited in the amount of resources at their disposal and very rarely engage in investment. An integrated financial sector would benefit from the information capital, cost effectiveness and savings mobilization capacity of the informal and semi-formal agents and combine this with the larger bulk sums and expertise at the disposal of formal institutions.

Creating a more integrated financial sector will also require strengthening the role of the semi-formal sector. Indeed, it must be empowered to fill the considerable gap in financial services between the formal and informal sectors. This is of particular importance in Africa as it concerns the financial needs of SMEs, key actors in the development process.

Policies

1. Coherent and shared vision for the financial sector and its role in the development process

African countries should encourage the creation of a broad-based and integrated financial sector and provide it with a shared vision, in order to enhance its role in the development process. This will require careful identification of appropriate participants from the various segments of the financial sector to maximize each participant's contribution based on its particular strengths.

The state should seek to develop a shared blueprint for the financial sector's role in the country's development. This would be based on the country's own development strategy and the aspirations and capabilities of the financial sector. A common vision of the sector's role in the development process could thus emerge and this could be concretized in the form, for example, of a Financial Charter specifying the aspirations of the sector and the attributions of specific roles within it as well as between it and the state.

Such a charter should seek to address the major deficiencies of the current financial sector. In particular, it should seek to address the fragmentation problem by encouraging greater communication and cooperation between the formal and semi-formal sectors while preserving their specialization. Among other issues, bridging the gap in financial services to facilitate SMEs' access to finance should be given prominence due to the importance of SMEs for employment and economic growth.

A Financial Charter should not be seen as a means for the state to impose its priorities and strategies on the financial sector. Indeed, although the charter can incorporate tools such as voluntary lending targets and ceilings, its main role should be to provide a shared vision that can create coherence and increase the economic and social returns of the activities of private sector actors through consensus-building and moral suasion. The charter would effectively serve as an embodiment of a common understanding of the role to be played by the various actors of the financial sector in the development process. Its content would therefore vary between countries to reflect their particular circumstances and development priorities. In South Africa for example, such a charter came into effect in 2004. It was the result of negotiations between the government, business community, labour organizations and community constituencies. Their main objective was to transform the financial sector into a leading force for the empowerment of black businesses that had traditionally been sidelined.

A Financial Charter developed in association with financial institutions can act as a powerful tool in transforming the financial sector into a key actor in the development process of African countries.

2. Tiered regulatory system to accommodate the different actors of the financial sector

The financial regulatory system should reflect the diverse nature of the financial sector in African countries. Putting in place a multi-tiered regulatory system could help the integration of its informal and formal segments. Indeed, a differentiated regulatory structure could accommodate existing informal institutions, permit experimentation and enable successful institutions to "graduate" towards more formality as their activities expand. In many countries today, the prudential regulations imposed on financial service providers act as a disincentive to formalization. In Benin for example, it has been noted that the burden of registration is such that many microfinance institutions that might otherwise have expanded their operations have been discouraged from entering the formal financial sector.

Agents in the informal financial sector provide vital services to individuals and small businesses that have no access to formal financial institutions. It is important that these informal agents are able to expand their activities if they are successful as this would contribute to increasing the depth, and reducing the fragmentation, of the financial sector. As they expand and their influence increases, it will be necessary for these institutions to comply with some level of prudential regulation. However, a small financial institution providing simple services at the community level should not be required to submit to the same level of regulation and reporting as a large formal sector bank. Differences in scale and influence should be recognized and should translate into a multi-tiered regulatory system that encourages expansion and matches regulatory burden to the level of risk that the failure of one institution imposes on the whole financial sector.

3. Credit information

The inability of financial institutions to readily obtain credit information on potential borrowers is a key factor limiting the supply of credit, especially to small businesses and poorer households. Indeed, without ready access to potential borrowers' credit histories, financial institutions are forced to either carry out costly research themselves or refuse to grant the loan given the risky environment within which they operate. It has been found consistently that improving credit information is one of the most important elements in expanding credit. Indeed, greater availability of credit information helps reduce the cost of risk that today forms an important part of the cost of finance in African countries. A credit information database should seek to tap the extensive knowledge of the informal financial agents in the framework of a well integrated financial sector as set out in the Financial Charter.

Setting up and maintaining a broad-based credit information database is both complex and costly. For this reason, the state may have to take responsibility for putting in place such an important information system. Alternatively, a public–private partnership with one or several private sector agents could be an optimal solution for such a venture. This database could be managed by a credit reference bureau from which all potential borrowers are required to obtain certificates of creditworthiness that should accompany their loan applications. Such a bureau should be tasked with providing both positive and negative references, which would require maintaining an updated list of creditworthy businesses or individuals. Countries should also consider designing and implementing policies that facilitate the use of assets as collateral security by simplifying and improving the transparency of rules and procedures that grant legal titles to such assets.

Namibia is one of the African countries undertaking steps in this direction through its land reform policy. Through its concession policy, Namibia provides a legal and binding contract between the state and a concessionaire (a community or a privately owned business) to operate a business on state land for a specified time frame. In a country where large tracts of land are state owned, this policy is intended to increase investment given that the concession is a legal document that is accepted as collateral when applying for a loan.

4. Facilitate formal financial sector service provision

Providing improved infrastructure (roads, electricity, telephone and internet access) could help expand the coverage of the formal financial sector. As such, the criteria for the construction of new infrastructure should include the extent to which it would aid the development of the formal financial sector, for example by reducing operational costs. Where necessary, such infrastructure could benefit from one-off state subsidies granted under an agreement to provide financial services according to mutually agreed guidelines. This could be used, for example, to encourage financial sector providers to offer additional business counselling services to SMEs to help them overcome their weaknesses and become more competitive. So-called “finance +” services can have an important impact on the performance of companies, which makes them more likely to be able to repay their loans.

In some countries, financial service provision can be expanded in underserved areas through the use of existing networks such as post offices, religious networks or producer cooperatives. These institutions have the advantage of already being in place and having a working knowledge of their setting. Additionally, they have generally learned to operate within the constraints of poor infrastructure and remoteness and can apply this adaptability to the provision of financial services.

The state can encourage the creation of appropriate institutions to support the extension and deepening of the financial sector. For example, a financial sector forum could be created to discuss issues of interest to the sector on a regular basis. A high-level committee consisting of the representatives of the state and of various segments of the financial sector could also be set up to meet, discuss and fine-tune policies of interest to the sector in an efficient and timely manner.

5. Build capacity for private actors in the financial sector and in regulatory bodies

The development of the financial sector to make it a key player in Africa's development process will require improvements in human capital. Better training, especially drawing on the successful experiences of African and other developing countries, can make a valuable impact both for firms and individuals in the sector. The creation or support of business schools or other specialized training institutions could represent a medium- to long-term solution to the problem of skills shortage in the financial sector.

Capacity-building is particularly important in the institutions charged with regulating and supervising the financial sector. Efficient supervision of the financial sector is necessary to avoid moral hazard and other risks that would restrict the sector's performance and affect people's trust in it. In addition, financial instruments are increasing in complexity and financial markets are becoming more globalized. Creating the necessary capacity in financial sector supervision should therefore be a priority of the reforms.

6. Set up pension funds and strengthen the insurance sector

Setting up or reinforcing non-bank financial institutions (NBFIs) such as insurance companies and pension funds can have a beneficial impact on the amount of resources available for investment and the capacity to deal with risk. Indeed, in countries where these institutions have extensive coverage, their assets form a large part of domestic savings. In Namibia for example, insurance companies and pension funds account for 57 per cent of assets held in the financial sector.

Additionally the resources mobilized by such NBFIs are often better suited for intermediation into productive investment than are bank deposits. This is because they are made up of contractual savings that have a much longer-term horizon than most bank deposits.

The benefits of setting up such institutions are not limited to the increase in savings that they generate. The creation of such institutions helps to diversify and deepen the financial sector. Additionally, pension funds and insurance schemes help limit the uncertainty people face by guaranteeing some income in their old age or in case of mishap. These institutions, therefore, help to limit and diffuse risk in the economy, and in turn dampen the precautionary motive for household savings held mostly in non-financial form or in the informal sector. If these savings are redirected into the formal financial system, as is most likely, they will have a greater development impact, as they will be available for further intermediation.

The experiences of Mauritius and Namibia demonstrate the beneficial influence that insurance and pension funds can have on the financial sector and on the economy at large. In Mauritius, NBFIs represent a very important segment of the financial sector. Assets held by the insurance companies alone were worth the equivalent of 19.2 per cent of GDP in 2006. Mauritius also has a number of public and private–public joint venture institutions that add to the density of the financial sector. These include the State Insurance Company of Mauritius, the Mauritius Civil Service Mutual Aid Association and the National Housing Development Company. In Sierra Leone, a National Social Security and Investment Trust was created in 2002 to serve both as a pension fund and as a source of funding for priority projects such as housing development. It is already providing financial security to over 100,000 people.

While the experience of countries such as Mauritius, Namibia and Sierra Leone demonstrate the benefits that can accrue from the creation of a strong pension fund and insurance sector, it also contains warnings for countries that would emulate them. Indeed, in Mauritius and Sierra Leone, the public pension fund has been used massively to fund government debt through investment in its securities. In Namibia, the investment portfolio run by the main pension fund has recorded losses of 50 per cent as a result of poor investment decisions, many of which were political in nature. It is therefore necessary to ensure that pension funds and other non-bank financial institutions are competently run and protected from political pressure particularly with regard to portfolio choices.

Given the relatively small size of formal sector employment, insurance funds may struggle initially to reach a size that allows them to sufficiently mitigate risks. In such cases, setting up funds at a multinational level, pooling resources from several countries from the same region, can help them to reach an adequate size.

7. Stock markets

The development of stock markets should be considered as a medium- to long-term strategy to deepen and diversify the financial sector and offer successful firms an additional source of funds for investment. They can play an important role in risk allocation and risk sharing by diversifying funding sources. In some African countries, such as Kenya and Zambia, the stock market attracts considerable amounts of capital from both domestic and international sources and plays an increasingly important role in mobilizing financial resources.

In many African countries, however, stock markets tend to have very low market capitalization and trade values. In fact, it has been found that stock markets usually only develop when economies reach a certain size and the level of capital accumulation is high. The creation of regional, rather than small national stock markets, could help to overcome this obstacle. However, the example of the Abidjan-based West African regional stock market shows that regionalization is not a panacea. Indeed, as discussed in a recent International Monetary Fund (IMF) study, there are prerequisites to successful regional stock markets. These include harmonization of national legislations, particularly bankruptcy and accounting laws, the establishment of reliable systems of electronic trading, central depository systems and a strong public sector regulatory oversight. Many of these prerequisites are missing in several countries.

It has also been noted that the current regulatory requirements may be unreasonably stringent and therefore discourage many firms from using the securities market for raising capital. A relaxing of regulatory rules could therefore allow a greater number of firms to benefit from it, which could stimulate the development of stock markets in Africa. It can, however, be expected that stock markets will develop faster when the real sectors of the economy attain high and sustainable growth rates.

8. Deposit insurance scheme

Several African countries have experienced severe banking crises in their recent history. These crises have often created a lasting feeling of mistrust with regard to banks and other formal financial institutions. To rebuild trust in the financial system, it might be desirable to put in place a deposit insurance scheme that protects small savers should their banks be in financial distress.

Such a scheme could increase moral hazard as it potentially allows banks to engage in risky lending knowing that their losses will be covered by the deposit insurance. Consequently, it is essential that such insurance only be undertaken if the central bank or other regulatory authorities dispose of the necessary capacity and ability to monitor the use of guaranteed funds. The success of such a scheme will depend on an efficient management of the financial sector underscored by better prudential regulation and supervision and strengthened enforcement mechanisms. Alternatively, the management of a deposit insurance scheme can be mandated to private sector entities.

9. Extend financial sector coverage based on technology and innovation

In recent years, innovations in information and communication technologies (ICTs) have had an increasing impact on the delivery of financial services in Africa as well as in other developing regions. These new technologies have helped to increase the coverage of the financial sector by reducing the cost of the infrastructure needed to carry out financial transactions.

The Equity Bank in Kenya has for example developed a way of increasing its delivery of financial services in rural areas without incurring the large costs involved in setting up a branch network. Instead, the bank has invested in vans that serve as mobile branches, visiting areas on a frequent cycle. Each van is equipped with the hardware and communication capacity to provide a large array of financial services. The bank has also combined this extension of coverage with new savings products more adapted to the needs of poor and rural households in order to attract their custom. As a result, the bank grew from serving 100,000 depositors in 2001 to serving 375,000 in 2004. By mid-2003 two thirds of its loan portfolio comprised clients served through mobile banking.

In South Africa, some banks have improved their cash delivery service to remote areas by installing ATMs (automatic teller machines) or even small bank branches that are powered through solar electricity and rely on satellite communications. In many other African countries, such as the Democratic Republic of the Congo and Zambia, financial services are now offered over mobile phones. Typically, this involves allowing customers who have a deposit account with a bank to make payments and transfers, as well as check their remaining balance via mobile phone. This technology allows depositors to access many financial services without needing to go to the bank branch. Additionally, it offers a valuable service to these customers by allowing them to make transactions without cash in countries where carrying cash can prove dangerous and where the use of debit and credit cards remains far from widespread.

The experience of these and other developing countries demonstrates the important potential created by new technologies for the improvement of financial service provision in Africa. These examples also highlight that, for this potential to be realized, financial institutions need to find the will and the creativity to exploit this potential. Institutions should seek to design financial products that respond to the needs of poor and rural households or of small businesses in remote areas. They should also seek the appropriate technology to be able to deliver these services to their clients at a low cost.

The state can play an important supportive role for this type of financial innovation. For example, the central bank, as part of its programme to develop the financial sector, can disseminate information on a regular basis highlighting the possibilities offered by new technologies and the ways in which these have been exploited by other developing countries. It can also take a more proactive role in facilitating the implementation of financial innovation. The state can complement this, for example, by assisting in the provision of the necessary infrastructure for these new ventures either on a grant or on a joint venture basis. It is also important that the state ensures that the prudential regulations and other relevant legal frameworks facilitate the testing and implementation of innovative financial products. To this end, the regulatory bodies should seek to work closely with financial institutions to follow the progress of operations and be able to make rapid adjustments in regulations to fit the evolving situation.

B. Development financing

Governments should seek to provide financial support for economic activities that play an important role in the development process but that experience difficulties in attracting private sector funding. These may include agricultural or non-farm rural activities that contribute to poverty reduction and employment creation. Some industrial activities may also need to be targeted by such funds to kick-start priority industries or remove production bottlenecks.

These activities, though important, may find it difficult to attract private financing due to the long-term nature of the investment projects, the difficulty for urban-based financial institutions of monitoring projects in rural areas or the large sums involved. Some of these activities are commercially viable, but lack private financing, while others have high social rates of return and/or huge multiplier effects on the rural economy.

Development banks were created in many countries in response to these needs. Their performance has however often been poor due to mismanagement, poor project selection and insufficient monitoring. As a result many of these banks have been dismantled or stripped of their developmental role during the market-oriented reforms of the past decades. There are nonetheless many examples in Africa of development banks that have succeeded in their mission and play an important role in the development of their country. In Mauritius, the development bank remains very active and provides various financial products including microfinance. Burundi's development bank also helps mobilize resources for priority development projects.

Development banks clearly have an important role to play in African countries. Past mistakes in their management do not diminish the relevance of development financing. These mistakes do, however, underline the importance of efficient management and of ensuring that development remains at the heart of their mission.

Development banks are not the only way of improving access to credit for important sectors of the economy. Strengthening microfinance institutions can also provide an efficient way of helping farmers and small businesses.

Policies

1. Reinstate development banks with a truly developmental agenda

Creating or reinstating development banks can provide governments with a powerful tool to pursue their development strategies. Development banks should act as a conduit for the government to improve funding for sectors that have been identified as crucial to the development effort. This can only be a viable strategy, however, if countries learn from the mistakes of the past and ensure these institutions benefit from rigorous and professional management and have the capacity to select and monitor the projects they fund in a scrupulous manner.

There are several options that countries may explore in order to fund the operations of development banks. In the past, part of ODA was channelled through these banks. Development banks must prove their effectiveness if they are to serve as a conduit for these funds again in the future. Similarly, national development banks can serve as intermediaries for regional and global development banks for their projects within the country. Such an arrangement would combine the funding and expertise of the larger development banks with the field knowledge of national development banks. This is particularly interesting in cases where loans from regional or international development financial institutions are not big enough to require the opening of a dedicated office in the beneficiary country. Governments also have the possibility of emitting long-term bonds to raise capital for development bank projects provided these projects can offer a return on investment in the time frame imposed by the bonds' maturity.

2. Create a microfinance fund

In Sierra Leone, two of the largest constraints to the operation of the microfinance sector have been identified as the insufficient funds at the disposal of microfinance institutions to expand their operations and the lack of a focal unit coordinating microfinance.

Both these problems could be remedied in great part by the creation of a microfinance fund.

A microfinance fund should help improve the access of small borrowers in both rural and urban settings to credit by increasing the resources available to microfinance institutions. Such a fund could be created from private bank contributions as well as from ODA. The central bank could also allow banks to hold reserves in the fund that would count towards their legal liquidity requirements. However, safeguards should be put in place to ensure that the objectives of the central bank in setting liquidity requirements are not compromised by its participation in the fund.

Unclaimed assets in the financial system (banks, insurance companies and pension funds) could also be channelled into such a fund. These assets can represent significant amounts. In Kenya, for example, such assets are estimated to be worth around $2 billion. The use of these assets for the purpose of a microfinance fund would, however, need to be undertaken only in association with adequate legislation regarding their definition and permitted uses. If the fund is efficiently run, it should enable the provision of small loans at lower interest rates than those currently charged by most microfinance institutions. In addition to providing working capital for microfinance, such a fund could promote greater communication and closer synergy between these institutions and those of the formal financial sector. It could, for example, promote the provision of on-the-job training and other capacity-building measures to strengthen the capacity of microfinance institutions.

C. The role of the central bank

Central banks can play a much greater role in promoting growth and development than the one they currently fulfil. Central banks in both developed and successful developing countries are engaged in credit allocation and the management of international capital flows. Yet central banks in Africa today limit their goals to stabilization and the use short-term interest rates almost exclusively as their tool. The main preoccupation of central banks in Africa today seems to be with inflation rates. It is believed that low inflation is crucial in promoting savings and investment as it removes the fear of financial capital losing value over time due to price increases. This type of policy, along with an emphasis on decoupling central banks from political power, has been actively promoted by donors and international financial institutions and enforced through market-oriented policies they have implemented in Africa.

There is no doubt that high inflation is detrimental to macroeconomic stability, a key objective that needs to be safeguarded. The problem arises when a narrow focus on implementing policies that achieve low inflation rates neglects the potentially negative impact of these policies on "real" variables such as unemployment, poverty and growth. In practice, inflation targeting often leads to highly conservative policies in terms of credit availability and restricts the opportunities for a trade-off between these variables and the level of inflation. Many economies, particularly in Central and Western Africa have very low levels of inflation but they are not the fastest growing economies. Indeed, some empirical studies have shown that the negative effects of inflation only occur at rates of inflation that are higher than the very low targets of 3 to 5 per cent pursued by central banks. While these could be the relevant rates for some countries, other countries could entertain higher inflation rates without any significant negative effect on other macroeconomic variables. Therefore, it is important that each country determines the optimum level of inflation that is compatible with its growth and other development objectives.

This is not to suggest that inflation should not be a preoccupation of the central bank. Indeed, many African countries have experienced first-hand the devastating effects of high inflation. Rather, it is suggested that the benefits of maintaining inflation rates at very low levels should be balanced against the costs that such a strategy imposes on the economy. This is particularly the case in instances where inflation is not caused by excessive government spending but is due to rising international prices for imported commodities, as has been the case in recent years. Applying tight inflation controls in such a case could result in a dampening of economic activity at an already difficult time and with no effect on the causes of inflation. In essence, each country should determine its own optimum level of inflation that does not compromise the country's development objectives.

Policies

1. Central banks should employ a real targeting approach to monetary policy

Instead of limiting their objective to keeping inflation low, central banks should also be concerned with the movements of real variables such as the employment rate and economic growth. This approach offers several benefits as it gives prominence to economic variables that have a clear and direct link with people's well-being. Thus, inflation targeting as a policy should not be pursued in isolation, but within a much larger context of macroeconomic management, where a wider array of policy tools are permissible. In situations where economic growth is anaemic and the unemployment rate is edging upwards, for example, central banks should be able to use expansionary fiscal policies to stimulate the economy. Additionally, this approach to monetary policy makes it much easier to adapt policies to specific country needs. The choice of an inflation target can then be tailored to the specific needs of the country and monitored as to its effects on other variables. This contrasts with a blinkered inflation targeting approach in which inflation is assumed to be the most important variable and low rates always desirable regardless of the effect on the wider economy.

2. Central banks should use sectoral policies to promote development

Central banks have been used successfully by several countries to promote sectoral and industrial development. Indeed, though the idea is often dismissed in policy circles nowadays, central banks have often played an important developmental role and continue to do so in newly emerging economies such as China and India.

This involves formulating monetary policy as an integral part of an economic policy package rather than as something separate and sacrosanct. Thus, if governments accept that the key objective of central banks should be inflation targeting, the chosen target should be sensitive to the movements of other real variables such as growth and employment. The central bank should not work in isolation, but in harmony with other institutions to attain the objective of high and sustainable growth and job creation. The central bank should try to identify and remedy the existing gaps in the financial sector. It can set up specific institutions to deal with deprived sectors. In India for example, the central bank has set up agricultural cooperative banks to raise funds and improve technical assistance in rural areas. It also set up an industrial finance corporation to supply long-term capital to the industrial sector.

The central bank should also use its regulatory power to achieve desired goals in the financial sector. In Namibia, the central bank has imposed a domestic assets requirement whereby institutional investors need to keep 35 per cent of their portfolios in national assets. This measure seeks to curb the important capital outflows to South Africa with whom Namibia has close links as they are both members of the same monetary union. Central banks in Africa must be active agents of development by playing a catalytic role in domestic resource mobilization. If, for example, the strengthening of microfinance is a development priority, the central bank can encourage banks to hold a certain proportion of their assets in a microfinance fund or extend a percentage of their total credit to SMEs.

Naturally, an expanded role for the central bank will call for additional capacity. In this respect, it is crucial that the central bank develop the administrative and technical capacity to deal with any new mission it takes on. Additionally, the central bank must imperatively be given the regulatory tools and independence to carry out its mandate optimally.

Chapter III

Increasing Public Revenue and Fiscal Space

A. The tax base is very narrow

Raising public revenue in African countries tends to be constrained by a particularly narrow tax base. Generally, a small number of people and businesses account for a significant proportion of tax revenue. This situation has often become more acute in recent years due to the fall in international trade taxes resulting from trade liberalization. These taxes had historically been the principal source of tax revenue in many African countries and remain so in countries such as in Sierra Leone where they account for 40 per cent of total revenues. Their value, however, is likely to be reduced in coming years in view of the continuing efforts at trade liberalization.

It is therefore crucial for African countries to seek to widen the tax base to increase overall tax receipts and to reduce the sometimes excessive burden currently imposed on a small number of large contributors. Efforts to augment tax revenues without widening the tax base, that is simply by levying higher taxes on existing taxpayers, is likely to have a negative effect on private savings. This occurred in Benin when a series of new taxes were introduced in the 1990s. These taxes were successful in raising the government revenue but only at the expense of private savings. They did not, therefore, have a positive impact on total domestic resource mobilization.

The large size of the informal sector in the economy is the main factor restricting the tax base in most African countries. Enticing more businesses to join the formal sector is therefore a crucial part of the strategy to increase government revenue. The decision of firms to remain in the informal sector can be seen as one of cost versus benefit. Other things being equal, firms will choose to be informal if the cost of entering the formal sector is higher than the benefits, as is the case in many African countries. By adopting a proactive stance towards SMEs, governments in African countries can entice more firms to enter the formal sector. It is important that governments use incentives rather than repressive measures to encourage formalization: this is more likely to be effective in the long run. On the other hand, it should be recognized that high illiteracy levels and the pervasiveness of infrastructural deficiencies in many African countries will keep a number of small commercial operations in the informal sector. These small firms should not be forced to bear the burden of formalization.

Similarly, tax collection will best be improved by visibly enhancing its equity and the good use of collected resources rather than simply by increasing the tax burden. It is, in fact, essential that the tax system be perceived to be fair and that tax resources are put to good use. If these conditions are not fulfilled, or if the tax system is unreasonably complicated, there will be little incentive for complying with tax obligations.

Policies

1. Facilitate the entry of firms into the formal sector

Encouraging firms in the informal sector to join the formal sector will mean lowering entry costs and increasing the advantages that formalization confers. Studies consistently show that many African countries, especially in sub-Saharan Africa, have high entry costs into the formal sector. Barriers include the exorbitant cost of obtaining a license or hiring staff that act as powerful disincentives for firms to join the formal sector. Facilitating the registration of firms and providing useful services such as training, improved access to credit, participation in business forums or assistance with import and export procedures, can help to induce firms to enter the formal sector voluntarily. The creation of a "one-stop shop" for businesses where they can register legally, obtain or renew licences, register property and fulfil their other administrative obligations is one of the ways in which states can try to reduce the administrative burden on firms. This was successfully implemented in Benin in 1995 and has contributed to improving the business environment in the country.

The benefits of these measures will accrue to the whole economy, and as such need not be justified only on the grounds of increasing tax revenues. However, it has to be emphasized that in terms of increasing government revenues, African countries are likely to gain significantly more by encouraging firms to join the formal sector than by heavily taxing the few that presently operate in it. Dramatic reductions in entry costs are possible as evidenced by the experience of Equatorial Guinea, where average entry costs were slashed by around 95 per cent in the space of one year simply by simplifying administrative procedures.

2. Ensure a fair and convenient tax system, and put public resources to good use

If more individuals and firms are expected to pay taxes, the state should ensure that the tax system is widely perceived as fair and that conforming to it is not unduly complicated from an administrative point of view. One important aspect of this will be to reduce political interference in the assessment and collection of tax revenues, in particular of politically connected individuals and companies. There is also a need to reduce tax evasion by demonstrating that the tax system is fair and that it benefits the country and its people in a broad manner.

One innovative way to improve the public's perception of the tax system is a taxpayers' charter as recently introduced in Zambia. It is the product of consultations between the tax authorities, taxpayers and civil society and sets out mutual commitments from both the tax authorities and taxpayers. Such initiatives can help create a climate of trust and accountability between tax collectors and taxpayers and improve tax collection.

The use of tax revenue will ultimately have a decisive effect on the efficacy of tax collection. Efficient public expenditure management that is seen to respond to the needs of the people is an essential part of reinforcing the legitimacy of the state. If taxes are perceived to be widely misappropriated, wasted on low priority areas, supporting corrupt officials or a widely discredited state, this will drastically lower the incentive of taxpayers to comply fully with their fiscal obligations. On the other hand, recent research from the United Republic of Tanzania reveals that a large majority of people were willing to pay more taxes if the resources were clearly going towards improving basic public service provision in their area.

3. Review tax policy

Many African countries could benefit from a thorough review of their tax policy. The tax system should aim to fulfil the three goals of equity, efficiency and administrative convenience. The review should be broad-based, cover all aspects of the tax system and facilitate greater collaboration between agencies that collect revenues and those that decide on their utilization. The precise nature of tax policy reforms will obviously depend on the specific features of individual countries.

Generally, tax policy reviews should focus on increasing revenue without imposing undue pressure on taxpayers. This will require improving the tax authority's efficiency and widening the fiscal base. African countries should also explore opportunities for developing non-tax revenues. These may include car park fees, advertising fees, royalties, licenses, etc.

Mining royalties constitute a potentially major source of public revenue in a number of African countries. Royalties should be a proportion of company sales given the problems associated with profit-based taxation. The issue is that due to asymmetric information and sometimes unequal capabilities between investors and host country, mining firms can use creative accounting practices to undervalue the level of taxes. Even the best regulatory authorities have had problems detecting these practices, let alone African countries that suffer from severe institutional weaknesses. In this regard, African countries should learn from the most successful experiences when negotiating the level of royalties. Otherwise, experience has shown that investors will not hesitate to exploit to their advantage the weaknesses of their host countries.

4. Review tax exemptions

Tax and duty exemptions can deprive countries of significant amounts of resources. Although tax concessions can be justified in some cases, many African countries could benefit from a thorough review of the concessions they have granted and the costs and benefits that these generate. In some cases, tax and duty concessions were negotiated from positions of weakness particularly in countries such as Burundi and Sierra Leone that are at their early stage of post-conflict reconstruction following devastating civil wars.

The grounds for awarding such exemptions must always be carefully examined. In many cases it has been found that awarding fiscal holidays to foreign firms represented a negligible factor in the decision to invest. Additionally, such tax exemptions are wasteful, difficult to administer and contain many loopholes that are easily exploited. They can also be difficult to renegotiate once they have been awarded. In Sierra Leone, for example, the exemptions that were awarded just after the civil war at a time when the country's bargaining position was weak are now proving to be costly in terms of foregone revenue and are delicate and time-consuming to renegotiate.

Existing and future tax concessions must therefore be carefully examined in terms of both their expected benefits and the potential revenue loss they entail. Alternative incentives should also be considered. A system of accelerated depreciation and capital allowances that targets capital investment could, for example, act as both a perk to investors and an incentive for them to invest in physical capital in the economy. This type of concession also has the advantage of being limited in time and easier to administer by the tax authorities. If combined with an income tax system that provides for moderate rates of corporate tax applied to both domestic and foreign companies to ensure a level playing field, accelerated depreciation and capital allowances could be a more effective means of attracting investments. Where exceptional circumstances necessitate tax and fiscal incentives (e.g., for the purpose of attracting foreign investment), these should be harmonized at the regional level or coordinated around best practice to avoid wasteful bidding and its associated "race to the bottom". Signing double taxation treaties with the home countries of foreign investors may also serve as an incentive for these investors to undertake investments they would otherwise not have made without tax incentives.

B. The tax collection system is inefficient

In addition to widening the tax base, improving the effectiveness of tax collection is an essential and related task that is necessary to truly improve public revenue collection. Indeed, it is not enough to widen the tax net if this is not accompanied by improved enforcement of collection, including enacting rules on tax avoidance, transfer pricing, etc. It is estimated that some countries could double their tax revenue by improving tax collection alone. Furthermore, well and fairly enforced tax collection strengthens the tax system by giving it added legitimacy. The low capacity of tax authorities has a negative impact on savings and investment in many African countries. In Sierra Leone, for example, tax authorities' lack of capacity leads them to tax firms on the basis of their physical assets rather than their revenue, which acts as a disincentive to capital investment.

Improving the capacity of tax collection agencies in terms of efficiency and monitoring will help them to carry out their mandate effectively. This will directly increase the amounts collected but also serve as a disincentive for tax evasion as the risks of being caught increase.

Policies

1. Invest human and financial resources to improve the tax collection system

Improving tax collection will require greater capacity within the tax collecting institutions, which points to the need for a reform of the public financial management system with a view to strengthening it in the long term. Human as well as financial resources will need to be invested to improve the quality and volume of tax revenue collected. Corruption in tax collection agencies must also be addressed by designing a system that rewards efficient and honest staff and imposes stiff penalties on the dishonest. Automation of the processes in tax administration offices could also limit the possibilities for graft as it reduces the interaction with different tax officials. This should be complemented with measures to encourage voluntary compliance and regular risk-based audits of firms and corporations.

A reorganization of the tax system along functional lines rather than tax handles will also enhance its efficiency. That is a system, at least for domestic taxes (i.e., non-import taxes), based on the different categories of taxpayers, with a large taxpayers department, a small and medium taxpayers department and specialized units for specific related activities such as auditing, research and legal affairs. Thus, each taxpayer pays all of his or her taxes to just one department, rather than to different departments depending on the type of tax (income tax, sales tax, value added tax, etc.) as is the case at present in some countries. One option that has been successful in many African countries is the establishment of revenue authorities in charge of all revenue collection for the state. Such an institution was created in Zambia in the mid-1990s and has successfully increased the proportion of direct taxes to an extent that has buffered against falling trade tax revenues. This functional organization is not only more efficient, it also reduces the scope for tax evasion. Furthermore, specialized skills can be most efficiently deployed if they are concentrated in specific units that can develop the necessary expertise and experience and focus their activities on areas of greatest need. Burundi has already implemented a structure like this whereby large enterprises and SMEs pay all their taxes to two different departments.

2. Reinforce border controls

One area in which rapid increases in revenue collection could be made in several African countries is the stricter control of cross-border trade. Despite a considerable reduction in international trade taxes in recent years, informal cross-border trading still represents an important loss of revenue for the state. Tighter controls could be accompanied by the setting up of a simple registration system for cross-border traders as well as measures to reduce the harassment of traders by customs officials. This would simplify customs procedures as well as dramatically reduce illegal crossings.

Chapter IV

Promoting Productive Investment

A. The private sector is unable to generate sufficient profitable investment opportunities

Weaknesses in the financial sector only constitute part of the explanation for low investment productivity in African countries. The demand side of financial services needs considerable improvements as well. The private sector in most African countries is heavily constrained. This is highlighted by the very poor rankings of many sub-Saharan countries in the World Bank's Ease of Doing Business Index as well as in its specific country surveys of the investment climate.

The extent of the demand-side problem in terms of investment can be seen through the high level of liquidity held by banks in many African countries. Indeed, even though the resources mobilized by banks are often limited in Africa, banks struggle to find sufficient economically viable projects to support. This is due, in part, to the limited capacity of banks to assess investment opportunities. However, there are also severe problems in the private sector that contribute to this situation.

Administrative barriers to private sector activity are considerable. These range from the cost of setting up a business in the formal sector to the number of operations required to comply with tax authorities or to settle a business dispute. The high costs of these administrative barriers are very difficult to bear for SMEs in the formal sector and go some way towards explaining the "missing middle" that exists between small informal firms and large formal ones in the private sector of many African countries.

As a result of the many impediments to private sector activity, firms often lack important skills for efficient operation. These include administrative skills, accounting and reporting skills, the capacity to deal with banks effectively or the ability to tap the opportunities offered by producing for export, including the enhanced market access offered by various bilateral and multilateral agreements.

The private sector, and especially the manufacturing sector, is also greatly constrained by the poor quality of infrastructure and basic service provision. Access to reliable supplies of electricity and water is essential for maintaining a productive manufacturing industry. Transport networks are crucial to move products from producers to consumers but are often of poor quality, imposing important uncertainties and inefficiencies as well as dramatically increasing costs of operation. More generally, the inadequate provision of basic services such as education and health has a negative impact on human capital.

In addition, the inability of the private sector to generate sufficient profitable investment opportunities is one of the causes of capital flight and therefore feeds a vicious circle by reducing the amount of domestic resources available for investment in the domestic economy. It has been estimated that a 1.0 per cent increase in capital flight reduces domestic investment by at least 0.11 per cent.

The private sector, and especially small firms, must be able to perform with fewer constraints. A vibrant private sector is necessary to create sufficient productive investment opportunities. It must become easier for firms, especially small firms, to operate in the formal sector. This implies remedying the many hindrances to their operation, improving their access to credit, helping them overcome their managerial and organizational weaknesses and ensuring the reliable provision of basic infrastructure and services.

Policies

1. Strengthen capacity of the private sector

Capacity-building in areas such as project design, administration, accounting and reporting, and import and export procedures can help firms in the private sector overcome some of the weaknesses that often result from the neglect of the sector in the past. State-sponsored capacity-building programmes can also act as an incentive for firms to relocate in the formal sector. Development partners could help support such capacity activities through ODA or technical cooperation. Private and development banks should also be encouraged to provide advisory services to help improve the quality of demand for financial services. The provision of so-called "finance +" services can help improve the profitability of investment while creating a closer relationship between banks and their clients.

2. Improve the legal and regulatory framework to reduce risks

One of the factors hindering the investment climate in Africa is the low level of protection given to investors and the difficulty of resolving business disputes through the legal system in a timely manner. These elements compound the difficulties caused by the high systemic and idiosyncratic risks that prevail in many African countries. Indeed, prospective investors need to contend not only with uncertain macroeconomic conditions but also worry about arbitrary decisions taken against them by public officials. Additionally, the legal system is often slow, costly, unreliable and extremely complex. The average dispute in sub-Saharan Africa takes more than one year, and over three dozen separate legal procedures, to be resolved at a cost of about 49 per cent of the amount in dispute. As a result, many businesses are forced to rely on informal contract enforcements, which are unpredictable. Stronger protection for investors and ensuring that the legal system is responsive to the need for swiftness in business disputes will therefore have a positive impact on the investment climate.

In general, African governments should seek to take a positive and proactive stance towards investment. This means not only removing or reducing the principal obstacles to investment that currently exist but also considering some regulatory measures to encourage greater investment, especially in sectors identified as development priorities. Benin, for example, implemented a series of measures to promote investment in the framework of the 1990 Investment Code. This code included clarification of property rights for both domestic and foreign investors, exemptions of import duties on capital goods for the first 30 months of installation for certain firms as well as exemption from business tax for a predetermined period of operation. These exemptions were used by the government to promote businesses in priority areas such as rural development and industrial transformation.

The legal system must be reformed in order to be able to treat business disputes in a timely and streamlined way. In the short term, credible commercial courts, sometimes called "fast track courts", can be created to expedite the treatment of business-related disputes.

B. Infrastructure financing

The poor quality of infrastructure in many African countries imposes large costs on the economy. The upgrading of much of the infrastructure already in place and the implementation of new infrastructure projects to provide more and better quality services such as potable water, electricity, communications and transport is therefore a top priority for development in Africa.

Investment in infrastructure tends to require large amounts of resources and long-term maturities. Domestic financial sector actors in most African countries often cannot take on such investments due to the shallowness of the financial sector and the difficulty they have in transforming short-term deposits into long-term investments.

Policies

1. Increase state provision of public goods

The state should prioritize public investment in physical infrastructural projects with "public good" characteristics such as roads, water and electricity generation and distribution in order to strengthen the private and financial sectors. This is particularly important in light of the mixed results of privatization experiences, particularly those of water supply both in Africa and elsewhere. African countries should also seek to act together to provide essential regional infrastructure, notably in transport, energy and communication. East African countries, for example, have pooled resources to build a regional dam that will produce electricity to be used in Burundi, Rwanda and the United Republic of Tanzania. In this regard, the New Partnership for Africa's Development (NEPAD) has launched a regional infrastructure initiative that aims at coordinating, facilitating and helping to finance important infrastructure projects at a regional scale.

Some of these projects will involve public–private partnerships. However, the public sector remains the main source of infrastructure financing in developing countries. According to some estimates, the public sector in developing countries accounts for 70 per cent of infrastructure finance, compared to 20–25 per cent from the private sector and 5–10 per cent from ODA. Considering the weakness of the private sector in Africa, the central role of the public sector in financing infrastructure projects in the continent cannot be overemphasized.

2. Facilitate loan syndication

Loan syndication can provide a practical way to privately finance infrastructure projects that are too large for individual investors to take on. The state should therefore seek to encourage loan syndication by, notably, ensuring that the regulations in place permit and protect syndicated loans. It might also be beneficial to provide some fiscal incentives for the providers of capital in cases where the project that is financed has important positive socio-economic externalities.

3. Create a long-term investment fund

The state can set up a long-term investment fund, similar to sovereign wealth funds, explicitly targeting large and long-term investments that are not "public goods" and that cannot be handled by individual financial companies. Such a fund could seek to pool together the resources of a wide array of financial sector operators with large cash reserves such as insurance companies, private banks or pension funds. In countries benefiting from commodity booms, part of the windfall profit can also be allocated to this investment fund. Deposits in the fund can be state-guaranteed provided the fund is professionally managed without political interference, and is therefore able to ensure the quality of the investment projects. Fiscal incentives for priority project financing could also be a way for governments to encourage the fund to provide capital for important infrastructure projects with large social and economic impacts.

The funds could also come from voluntary contributions from public and private institutions. The high levels of liquidity of commercial banks in many African countries suggest that such investment opportunities could be attractive to institutions such as banks or pension funds for example. External assistance, in the form of ODA contributions, could also help to kick-start such a fund.

This fund could have a dramatic impact on the level of investment. For example, the 2007 edition of the *Economic Development in Africa Report*, one of the flagship publications of UNCTAD, cites a finding that if half the annual profits of Burundi's eight commercial banks, two development banks, the largest insurance company, a brewery and a sugar factory had been invested in the national economy, they would have increased the country's capital formation from 15 per cent of GDP in 2004 to 23 per cent in 2005.

4. Develop or deepen capital markets

In the medium to long term, governments should promulgate legislation and design the necessary institutions to develop and/or deepen capital (bond and equity) markets, including setting up venture capital funds. These markets can be boosted by raising institutional capital through pension reforms.

Bonds can be an efficient way for the government to raise long-term financing for infrastructure projects. In addition, capital markets and venture capital funds represent a more sustainable way of financing government borrowing than short-term treasury bills, particularly in terms of their impact on macroeconomic stability.

Such an approach was followed successfully in Benin. In December 2006, the Government of Benin issued a five-year bond on the West African regional stock market. The 60 billion CFA francs raised in a very short period of time were one and a half times greater than expected. It is believed that an important proportion of money raised was in fact mobilized by informal agents. Several factors appear to have contributed to the success of Benin's strategy. Firstly, there was a widespread advertisement campaign for the bonds. Secondly, the interest rates offered were significantly better than those for bank deposits (6 per cent compared to 3.5 per cent). And finally, interest rates on bonds receive tax exemptions in Benin.

In cases where the investment entails marketable goods, such as electricity, governments could explore public–private partnerships and joint ventures.

Chapter V

Remittances and Capital Flight

A. Remittances

Remittances represent major capital inflows to many African countries and there is good reason to believe that it is possible to augment their impact on development beyond the current level. Indeed, remittances are mainly used for consumption at present and they are often transferred in ways that bypass the formal financial sector. However, a distinction can be made between remittances that are transferred mainly for purposes of assisting poor relatives and remittance transfers that are closer to investments in their nature. Reducing the transaction costs on the former type of transfer can increase their developmental impact, although it is with the latter type of remittance transfer that the potential is largest. Indeed, such transfers occur as a result of a portfolio choice to invest in the receiving country rather than elsewhere. They are therefore much more sensitive to transaction costs and the conditions of investment in the receiving country.

Providing appropriate institutions for the transfer of remittances with minimum transaction costs from their originating country to the beneficiary could therefore induce more remittances to flow through formal channels and strengthen the financial sector. It could also induce a larger amount of remittances to be made available as resources for investment.

Policies

1. Engage with the private financial sector – possibly in the context of the financial charter

The financial sector should seek to improve the relevance and quality of their services with regard to remittance transfers in order to attract a larger proportion of these flows into formal transmission channels. This could form part of the discussion on the role of the financial sector in the development process as considered in chapter II.

Giving nationals living outside the country the possibility to keep a bank account in foreign currency in their home countries without prohibitive charges could, for example, help increase remittance transfers. It would ensure that their savings are safe from devaluation of the national currency, reducing the risk of them losing their value.

Other successful policies involve offering investment opportunities tailored to the diaspora. One bank in Burundi, for example, offers the possibility for Burundians residing abroad to invest in real estate using their remittances. This provides a valuable service as it is very difficult to purchase property or build a house whilst residing abroad. The savings of the Burundian diaspora who showed interest in this project reached $1.5 million in 2007, the launch year.

In Mexico, where remittances are the third largest source of external finance, an increase in the number of United States-based institutions serving the country (from 5 to 100 between 2000 and 2005) led to stiffer competition. This resulted in transactions costs being slashed by half and significant growth of the total amounts sent home by the diaspora. Moreover, the generalization of electronic transfers using debit and credit cards to transfer money resulted in higher remittances mediated through official channels. These factors could help Africa increase both the total amount of remittances and the proportion sent through official channels.

2. Host countries of diasporas can help lower transaction costs on remittances

The countries from which remittances originate should consider taking action to reduce the transaction costs on remittance transfers that use formal channels. For example, these countries could offer tax breaks on the sums remitted, thereby lowering the final cost. These tax breaks could be considered as development assistance for the receiving countries, constituting a novel and indirect way of delivering aid to the private sector. An added advantage of this would be the enhanced transparency of remittances, which would facilitate the identification of remittances for illegitimate purposes such as funding acts of terrorism.

3. Create diaspora bonds

The government can create sovereign bonds especially tailored towards the diaspora. The diaspora tends to be more interested in assisting the country's development and has more knowledge about the country's situation than other foreign investors. Countries such as India and Israel have both launched such an initiative and have been able to raise considerable amounts of funds in this way. It has been estimated that the potential savings of the African diaspora are between $10 billion and $30 billion.

4. Use remittances to guarantee government bonds

Several Latin American countries have used expected future flows of hard currency from remittances to securitize bonds in order to give their bonds better investment ratings. These remittance-securitized bonds can help countries tap into international capital markets to finance important projects such as infrastructure.

B. Capital Flight

Capital flight is not a clearly defined concept. As a result there are a number of different definitions and methods for measuring the phenomenon. The main difference between various definitions of the phenomenon is whether it covers all outflows of capital, including those not captured in the balance of payments statistics, or whether it seeks to isolate particular episodic surges in capital outflows. For policy purposes, it is useful to define capital flight as private assets held abroad. A certain proportion of these assets leave their country of origin simply as the result of a portfolio choice to invest in foreign markets that may be safer or offer better returns. There is also a sizeable portion of these assets that are composed of the proceeds of criminal activities and that are therefore fleeing the country to avoid being detected, used as evidence against their owners and eventually confiscated.

These definitional problems naturally lead to widely differing estimates as to the magnitude of the problem. Even estimations using conservative definitions of capital flight do however show how important the resource loss is to Africa. The most recent estimates value the total stock of African capital flight stock at 82 per cent of GDP. This represents $607 billion in 2004, which is nearly thrice the value of the entire external debt stock of the region.

However, the burden of capital flight is unequally distributed amongst African countries. Sierra Leone has the highest ratio of accumulated capital flight over GDP, at 425 per cent in 2004. The figure was 344 per cent in both the Congo and Zimbabwe, and 312 per cent in Burundi. Benin, Niger, Senegal and Togo have negative figures, suggesting that capital inflows have been considerably larger than outflows in these countries.

Policies

1. No-questions-asked amnesty on capital flight repatriation

The dual nature of capital flight suggests that a good part of it might be prevented if more investment opportunities were created, which is the aim of the policies in chapter IV. Preventing "portfolio choice" capital flight is only one aspect however. Countries that suffer from capital flight should seek to attract some of the large stock of capital flight back into the country and should also take measures to reduce the size of criminally-induced capital flight.

Assets held abroad to evade the law will only return to the originating country if the owners of these assets feel that they are safe from prosecution and that their assets are also free from expropriation. This obviously constitutes a "reward" for criminal activities. It may nonetheless be expedient to offer an amnesty as a time-bound measure to attract capital into the country. In Italy for example, a one-year amnesty on private holders of foreign assets yielded $30 billion from Swiss banks alone.

The success of such a policy is largely dependent on careful phasing. Indeed, capital will only be attracted back to the country if sufficient profitable investment opportunities are created. If the domestic economy is attractive enough, holders of capital abroad may consent to the implicit trade-off of capital repatriation. Indeed, while the owner of capital benefits from being able to repatriate his assets, he also acknowledges his past faults and implicitly accepts a higher level of scrutiny in the future.

2. Cooperate with foreign banks and governments

Another approach to the repatriation of illegally acquired assets held abroad is to use legal channels to impound these assets and forcibly repatriate them. These assets are generally held in foreign banks. Not having jurisdiction over these institutions makes it very difficult for African countries to apply pressure on them to obtain repatriation or even information on assets held there. Increased cooperation and dialogue with banks combined with appeals for assistance from governments of countries in which the assets are held could help to identify and repatriate some of these assets. Failing this, a "naming and shaming" approach has proved successful in some high profile cases to obtain the repatriation of illegally gained assets.

Conclusion

This policy handbook seeks to propose different ways African countries could mobilize increased volumes of domestic resources to support their development objectives. The financial sector and the system of revenue collection are both critical to the success of such an endeavour. As such, the handbook discusses policies that may be useful for tackling well known issues of financial sector weaknesses that are pervasive in Africa and the inefficiency of the tax collection system. It proposes policies that seek to strengthen the financial sector to enable it to better perform its role of financial intermediation by encouraging savings mobilization and improved resource allocation. It argues that the allocation of savings to priority projects in African countries plagued by imperfect markets, weak infrastructure and associated impediments to private sector activities will require a central bank with a more flexible and proactive developmental role. That is, a role that goes beyond inflation targeting to one based on policy trade-offs between inflation, economic growth and job creation. Policies relating to the reform and reorganization of the tax system should enable scarce expertise to be deployed more effectively, as well as improve the efficiency of collecting tax revenues by encouraging the willingness to pay and reducing the opportunities for evasion, thereby increasing overall tax take.

Informal sector activities account for a large proportion of the GDP of most African countries and have to be taken into consideration in any policy recommendations aimed at stimulating growth in these economies. The policy recommendations in this handbook therefore aim at improving the efficiency of production in this sector, which will also expand taxable activities being undertaken. Similarly, reversing capital flight and increasing remittances will expand the volume of development financing available to these countries without creating any future debt obligations.

It should be stressed that this handbook does not intend to provide a ready-to-use blueprint for enhancing domestic financial resource mobilization in African countries. Rather, it seeks to highlight some potentially interesting sources of revenue while outlining a number of possible policy tools that can help decision makers in Africa mobilize those resources. While some of the policy proposals contained in the handbook may seem unconventional, or at least at odds with the current economic orthodoxy, they have been drawn essentially from successful experiences in African or other developing countries and have been widely debated among government officials and development practitioners, including civil society organizations in Africa. A key message of this handbook is that the state should seek to do more to stimulate domestic financial resource mobilization and ensure that resources are effectively allocated. Above all, the success of policies advocated in this handbook will depend on a coherent overall vision for development, the provision of an enabling environment and careful phasing of policy implementation.

There are no guarantees that policy changes will always be successful on the first try. Indeed, "learning by doing" will be a fundamental mechanism of the development process. As time passes, the capacity to monitor and improve policies will grow and policies will be increasingly fine-tuned to the particular needs of each country.

The problems of implementation notwithstanding, the potential benefits of successful policy reform are enormous. Indeed, improved mobilization and use of domestic resources will reduce the overdependence of African countries on external sources of capital. It will also strengthen the economy and the capacity of the state to identify and pursue a truly nationally-owned development strategy.

Recent improvements in governance, exemplified by the African Peer Review Mechanism of NEPAD and the greater stability of African economies compared to previous decades, offer hope for the future of Africa. These positive developments suggest that African countries are probably ready to deepen the ownership of their development process. It is within this context that the policies presented in this handbook on domestic financial resource mobilization and efficient use in Africa could truly help further and sustain the ongoing development efforts deployed across the continent.

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