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The future of financing for development in Africa

Insights from the Annual Meetings of the AfDB in May 2015

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Key messages

One of the reasons for the failure of the Millennium Development Goals and past international Financing for Development conferences was the absence of a strong growth agenda. In order to raise the necessary finance for the implementation of Africa's development agenda, including the sustainable development goals, African countries will need to concentrate on boosting economic growth and reducing income inequality.

African governments need to take a developmental approach to domestic resource mobilisation that focuses on improved tax administration, the provision of critical public services and support for private-sector productivity.

A concerted international effort to combat illicit financial flows is extremely important for assisting African countries to mobilise financial capital for development. Curbing illicit financial flows requires more domestic capacity for fighting corruption as well as better international cooperation on tax and money-laundering issues.

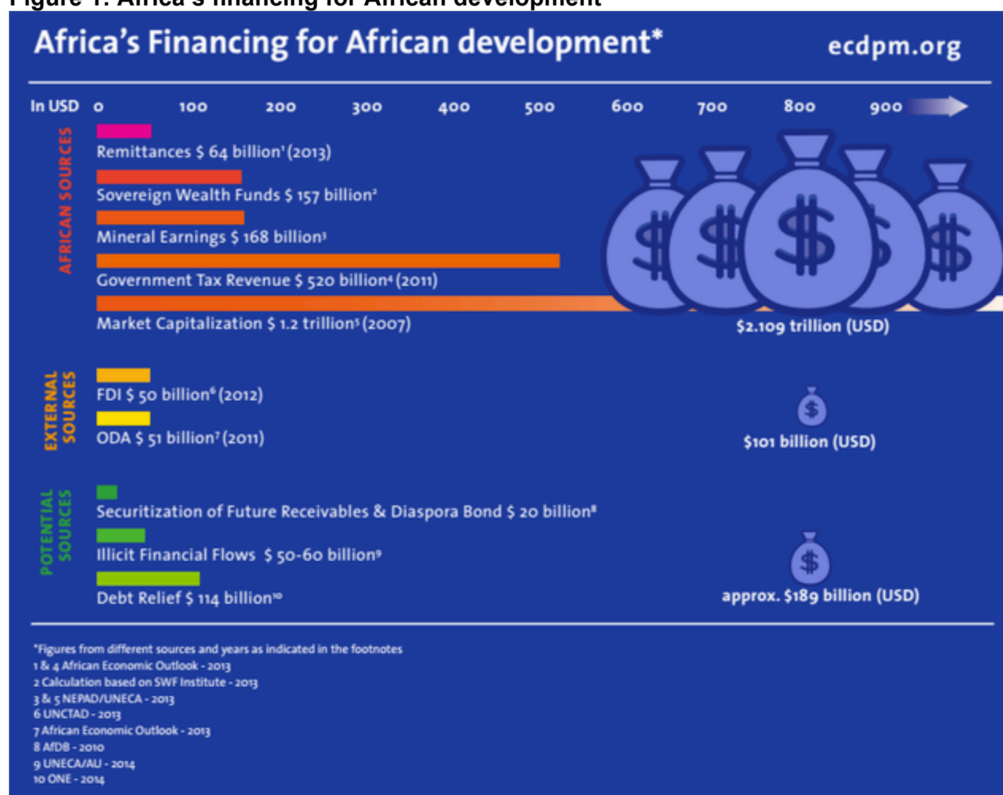
Introduction: the current state of play

A critical focus of African and world leaders in 2016 and beyond will be how to develop concrete and actionable policies to support the implementation of the Sustainable Development Goals (SDGs). How to ensure sustainability and achieve greater impact have been key elements shaping thinking around the post-2015 development agenda. Underlying these considerations is also the question of how to effectively raise finance for the implementation of the SDGs. The general consensus is that insufficient financial resources and inadequate policies will make the post-2015 goals unattainable, particularly in Africa. This was the context in which the Third International Conference on Financing for Development (FfD) was held in Addis Ababa, Ethiopia, from 13 to 16 July 2015.

It was clear from the outset that the stakes for the third FfD summit process would be much higher than at past conferences. Unlike the first conference in Monterey, which came two years after the adoption of the MDGs, the third FfD conference was strategically scheduled as the first of four major multilateral meetings in 2015. The hope was that the outcome of the third FfD conference would pave the way for the summit to set the post-2015 development agenda in September, the UN Framework Convention on Climate Change in December, and the tenth ministerial conference meeting of the World Trade Organization, also in December.

The issues to be addressed during the third FfD process were also more challenging due to recent changes in global dynamics. The global financial crisis has depressed tax revenues in many developed countries and has been a warning sign to many developing countries that foreign financial resources will not always be readily available. In recent years, official development assistance (ODA) has fallen short of commitments, and foreign direct investments and remittances have overtaken ODA as the leading sources of foreign capital flows into Africa. At the same time, new sources of development assistance are emerging from the South, although the modalities of South-South and North-South partnerships remain unclear. Accordingly, the third FfD conference focused largely on improving domestic resource mobilisation, encouraging private capital flows and defining a new partnership for development financing.

Figure 1: Africa's financing for African development



The challenge now for Africa is how to build on the FfD process and increase actual FfD. The discussions during the Annual Meetings of the African Development Bank (AfDB) in May 2015 offer an interesting insight into Africa's approach to FfD and some of the critical issues facing the continent in 2016 and beyond. This briefing note details some of the key insights shared by African ministers and top economists during the meetings.

Overall, while African governments generally acknowledge the support provided by ODA, they are now placing greater emphasis on the need for structural economic transformation and domestic resource mobilisation (DRM). The future of FfD in Africa will therefore be a question of:

1. promoting inclusive growth;
2. improving legislative and public-sector capacity to generate more domestic tax revenue;
3. improving public financial management;
4. combating illicit financial flows (IFFs).

1. Financing development and promoting inclusive growth

At the AfDB's Annual Meetings, the former president of the Bank, Donald Kaberuka, explained that the Millennium Development Goals lacked a growth agenda. He said that this significantly detracted from the Bank's ability to accomplish its mission.[1]

Indeed, the MDGs overlooked the fact that countries provided public goods by redistributing the benefits of growth with the aid of progressive taxes and public spending. Past FfD conferences in Monterrey and Doha had focused largely on the money needed to meet particular targets without giving due attention to the fundamental issue of economic growth. Yet the best performers in terms of reducing poverty and meeting the MDGs had not achieved success solely by spending more public money, but rather by increasing growth. African countries like Ethiopia, Rwanda and Mauritius had made great strides in achieving the MDGs largely by focusing on improving economic performance. Moreover, the excessive focus on aid at past FfD conferences was also incredibly risky. As the recent global financial crisis had demonstrated, ODA was highly volatile and developed country governments would not meet their ODA obligations when faced with their own economic constraints.

The future of FfD in Africa will therefore hinge on boosting economic growth. As Daniel Zelikow, Global Head of the Public Sector Group at JP Morgan, explained, the meaningful money for development would have to come from the domestic private sector. Foreign direct investment was volatile and largely concentrated in East Asia. Africa therefore needed to grow its own domestic market.

At the same time, an exclusive focus on growth is not enough. As UNECA Executive Secretary Carlos Lopes explained, African countries needed to aim for inclusive growth. According to the AfDB, Africa has grown at an average rate of 5% over the last ten years, thanks largely to improved macroeconomic and political governance, successful business policy reforms, greater domestic demand and high commodity prices.[2] However, this growth has been concentrated largely in certain sectors and has not significantly increased incomes for the majority of the population. As the International Labor Organization recently reported, despite a 7.7% unemployment rate in Africa, the number of working poor or people in vulnerable forms of employment represented 76.6% of the labour force in 2014.[3] High levels of poverty have thus paradoxically coexisted with rising economic growth in Africa.

The potential for taxation and other forms of domestic resource mobilisation will be constrained without policies to address income inequality and economic diversification. As a recent study by the Overseas Development Institute (ODI) demonstrated, the impact of growth on poverty is mediated through inequality. For example, the ODI noted that, 'at a growth rate of 2% per head and a poverty headcount of 40%, a country with low inequality could halve poverty in ten years, while a country with high inequality would take nearly 60 years to achieve the same reduction.'[4] In order to promote inclusive growth and increase incomes, African countries will need to focus on diversifying their economies by improving the business environment for investors and, more importantly, by enhancing the productive capacity of their small and medium-sized enterprises (SMEs).

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1 Author's notes. Annual Meetings, African Development Bank, Abidjan, Ivory Coast, May 2015.
2 African Development Bank (2014). *African Economic Outlook 2014: Global Value Chains and Africa's Industrialization*. Tunis, Tunisia: AfDB.
3 World Employment and Social Outlook: Trends 2015, International Labour Office. Geneva: ILO, 2015.
4 Overseas Development Institute (2010). "Economic growth and the MDGs Growth is important for the MDGs, but governments must focus on how the benefits are distributed." See: http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/5995.pdf.

2. Improving the business environment and expanding the tax base

At the AfDB's Annual Meetings, the Prime Minister of the Democratic Republic of Congo, Augustin Matata Ponyo, argued that development and domestic resource mobilisation are not incompatible with profit.[5] His statement emphasised the crucial link between inclusive growth and DRM. Given the right policies, the more profits the private sector makes, the more the state can benefit from taxation and the more finance is available for development. Accordingly, African governments need to take a developmental approach to DRM: one that focuses both on improving their tax administration and on boosting private-sector productivity.

Many African governments recognise the potential for boosting tax revenue and have introduced tax policy and administrative reforms over the past decade. As a result, the continent's total tax revenue quadrupled from USD 137.5 billion to USD 527.3 billion between 2000 and 2012.[6] However, much of the increase in tax revenue is due to a rise in natural resource rents. African countries continue to collect a significant proportion of their direct taxes from a narrow base of formal businesses and civil servants. This is largely the result of low administrative capacity and the relatively low incomes in the continent's large informal sector.

Figure 2: Tax Revenue mobilisation in Africa (1996-2010)

Source: Bhushan, A., Samy, Y. and Medu, K. (2013).

Accordingly, UNECA Executive Secretary Carlos Lopes argued that Africa needed to expand its tax base by paying greater attention to the informal sector. So far, the response of the international community and African governments to the informal sector had been inadequate, he claimed. This was despite the fact that informal small and medium-sized enterprises (SMEs) played an important role in reducing poverty and fostering equitable growth. Indeed, informal SMEs made up the majority of firms, employing 80% of sub-Saharan Africa's labour force and contributing around 55% to its GDP.[7] Despite this, informal firms faced major growth constraints, including undercapitalisation, skills shortages, weak market linkages and a widespread lack of business development services and networks. In addition, corruption and burdensome government regulation often compelled profitable SMEs to remain informal.

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5 Author's notes. Annual Meetings, African Development Bank, Abidjan, Ivory Coast, May 2015.

6 African Development Bank. (2014). *African Economic Outlook 2014: Global Value Chains and Africa's Industrialization*. Tunis, Tunisia: AfDB.

7 Ncube, M. (2013). Recognizing Africa's Informal Sector - African Development Bank [Blog Post]. Retrieved from http://www.afdb.org/en/blogs/afdb-championing-inclusive-growth-across-africa/post/recognizing-africas-informal-sector-11645/.

African governments therefore need to improve the conditions for firms operating in the formal economy. Potential measures in this connection include simplifying taxation, guaranteeing property rights and improving access to finance. As Carlos Lopes explained, Latin American countries such as Brazil and Mexico supplied good examples of how the informal business sector could be formalised. Latin American governments had successfully introduced simple taxes levied on gross corporate revenues as substitutes for VAT or income tax. These schemes also included certain social security and business registration provisions that had facilitated the formalisation of informal SMEs. African governments could leapfrog Latin America by using mobile banking and other new financing programmes to improve SMEs' access to finance.

3. Improving public financial management

Underlying any strategy for boosting tax revenue in Africa is the need to enhance government accountability through the provision of critical public services. Regardless of what tax policies governments adopt, they will not raise more tax revenue if citizens have no confidence in the state's ability to utilise resources efficiently and in a manner that will improve their lives. For this reason, Carlos Lopes and Augustin Matata Ponyo argued that Africa needed to learn not only how to generate, but also how to manage domestic resources. There is a huge potential for greater DRM in Africa, especially since fiscal pressure is very low and governments have not paid much attention to the way in which savings are invested. Indeed, considerable resources could be generated for financing development by strengthening public expenditure and investment.

As the World Bank claims, the better selection, design and management of public investment projects could help limit waste and graft and improve the quality of public expenditure.[8] A study by McKinsey & Company, for example, suggests that developing countries could save USD 250 billion annually in infrastructure investment by improving public financial management.[9] Although budgeting processes in Africa have improved considerably, African countries face major challenges in terms of overseeing and tracking expenditure. National accounting and auditing systems are often fragmented among different ministries or tiers of government, thus weakening coherence in the spending of public funds and making wastage and duplicate spending more likely. Public financial management reform can thus help governments move to single accounting systems across ministries, adopt centralised planning and budgeting, and monitor spending centrally.[10]

According to Olukorede Adenowo, the Managing Director of West and Central Africa at Standard Chartered Bank, improved public financial management is also critically important for private sector development. Better and more predictable fiscal spending would give the private sector greater confidence in the economy and in turn facilitate higher levels of private sector investment and job creation, he said.

According to a study by Ernst and Young, public financial management reform can help ensure that infrastructure projects are completed on time and that the government is more reliable in paying private-sector contractors. As African governments compete to make their countries attractive to foreign investors, the reform of public financial management can play a crucial role in creating an attractive environment for foreign capital flows.

Importantly, improved public financial management can help governments achieve inclusive growth and raise economic productivity. As Augustin Matata Ponyo (the Prime Minister of the Democratic Republic of Congo) explained, part of Africa's domestic resource mobilisation strategy should revolve around improving public financial management so as to generate adequate investment in health and education. Health and education, he argued, were critical to producing a competitive labour force that could actively engage in profit-making activities in the private sector.[11] Taking this argument further, he claimed that African governments could guarantee the equitable distribution of private-sector gains by increasing public

[8] The World Bank Group (2013). Financing for Development Post-2015. https://www.worldbank.org/content/dam/Worldbank/document/Poverty%20documents/WB-PREM%20financing-for-development-pub-10-11-13web.pdf.

[9] Dobbs, R. et all. (2013). "Infrastructure productivity: How to save $1 trillion a year," McKinsey Global Institute.

[10] Ernst & Young (The Rewards of Reform: Public Financial Management Reform in Africa. http://www.ey.com/Publication/vwLUAssets/EY-The-reward-of-reform/$FILE/EY-The-reward-of-reform.pdf.

[11] African Development Bank, Annual Meetings, May 2015.

investment in infrastructure, health, education and agriculture. In addition to reducing public-sector corruption, government reforms of subsidy regimes and procurement systems could raise the efficiency of public spending and allow more money to be spent on poverty reduction.

4. Tackling illicit financial flows

Eloha Otobo of the Global Governance Institute claimed that illicit financial flows (IFFs) from Africa dwarfed official development assistance. Indeed, the African Union's High-Level Panel on Illicit Financial Flows found that Africa had lost in excess of USD 1 trillion in IFFs over a period of 50 years.[12] Apart from representing a staggering loss of revenue, IFFs encourage the misallocation of human and capital resources and crowd out legitimate activities that could potentially be taxed.

According to estimates, 60% of IFFs from Africa are the result of corporate activities including transfer pricing abuse, trade mispricing and the misinvoicing of services and intangibles. Unequal contracts and poor tax monitoring have resulted in African governments losing billions of dollar in revenue to foreign corporations.[13] For example, Zambia concluded in 2008 that the Mopani Copper Mine was selling copper to its main stakeholder, Glencore, for prices far below those on the international market. In 2006, a review of 105 natural resource concessions in Liberia identified 36 contracts for out-and-out cancellation and 14 for renegotiation because the government was not receiving fair value for money from them.

In this light, curtailing IFFs must be a critical component of any strategy for raising more domestic resources. IFFs rely greatly on parallel financial organisations within government institutions (e.g. national oil companies) and offshore companies in tax havens and foreign banking centres. The UNECA claims that the European Union, the United States, Canada, Japan, the Republic of Korea, China and India are the top destinations for illicit financial flows from Africa.[14]

Combating IFFs therefore requires more domestic capacity as well as better international cooperation on tax and money-laundering issues. By granting investors tax exemptions, particularly for imports of capital equipment, African governments are inadvertently encouraging transfer pricing. In addition to eliminating tax exemptions, governments can counteract transfer pricing abuse and false invoicing by exercising their auditing rights. Country efforts to improve governance and public financial management can also help stem IFFs in the public and private sectors.

There is a need for greater international cooperation to combat IFFs. Civil-society organisations maintain that one of the major failings of the Addis Ababa Financing for Development Conference was rich countries' insistence on limiting discussions on taxation and IFFs.[15] Developing countries should continue to press for greater involvement in international discussions on taxation and should work with developed countries on asset recovery. Developed countries will need to address the issue of IFFs and imbalances in global taxation if they are to remain credible in their insistence that developing countries should take greater responsibility for financing their development.

Nevertheless, the recently launched Addis Tax Initiative is a welcome development that can help African countries improve their corporate tax administration. AfDB programmes on contract negotiation can be of particular help to Africa's mineral-rich countries. Donor countries can support developing countries by providing them with opportunities for greater participation in the OECD-led Global Forum on Tax Transparency and Exchange of Information for Tax Purposes.

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[12] United Nations Economic Commission for Africa (2012). Illicit Financial Flows from Africa: Scale and Development Challenges. Background paper by the High-level Panel on Illicit Financial Flows from Africa, Lusaka, Zambia.
[13] Ibid.
[14] Ibid.
[15] Declaration from the Addis Ababa Civil Society Forum on Financing for Development (12 July 2015): https://csoforffd.files.wordpress.com/2015/07/addis-ababa-cso-ffd-forum-declaration-12-july-2015.pdf.

Conclusion

African governments have shown great enthusiasm for developing innovative ideas for financing for development. The third International Financing for Development conference was a good start in terms of emphasising the need for better domestic resource mobilisation. To effectively raise finance for development, however, African governments will need to create conditions for inclusive economic growth and at the same time improve tax policy and public financial management systems. Moreover, international efforts to combat illicit financial flows can help Africa to raise the resources needed to finance its development. Ultimately though, such reforms will accomplish little without political stability and inclusion, government accountability and transparency, social protection, and the availability of key infrastructure and public services.

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