



Mobilisation and effective use of domestic resources for a transformative post-2015 agenda

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Summary

This briefing discusses the mobilisation and effective use of domestic resources (government revenues and domestic private finance) for a transformative post-2015 agenda.

The revised working document for the 11th session of the Open Working Group includes a set of goals (focus area 15) related to the mobilisation and effective use of domestic resources.

Tax revenues (as % of GDP) increase with higher levels of income, but with variation across regions and time periods. Whilst tax-to-GDP ratios have been rather static over time for several country groups, there is buoyant performance for upper middle income countries (UMICs), a small but important gain for low income countries (LICs), and marked differences across individual countries.

Provisional estimates for the European Report on Development 2014 suggest that for the group of LICs and MICs and in 2011 prices “Tax revenues have increased 407%, from \$809 bn in 1995 to \$4,107 bn in 2012”. And for LICs “tax revenues have seen rising levels of tax revenues (from \$20 billion in 1995 to \$60 billion in 2012)”.

There are a number of dynamic trends across different types of taxes in developing countries: VAT, trade taxes, personal and corporate income tax and property and land taxes.

There is a range of general and specific factors that can help to raise tax revenues, such as building capacity in tax administrations or improving the tax base (formal sector earnings and private spending). A number of specific tax challenges arise from taxing extractive industries, such as transfer pricing and transparency issues.

Public subsidy reform and better procurement are also important in the context of domestic resource mobilisation.

The mobilisation and effective use of private savings and finance is a further challenge. Private resources from domestic pension funds and insurance companies have grown dramatically in developing countries reaching US\$5.5 trillion in 2012, ten-fold the levels seen in 2002 (World Bank 2013) are expected to increase further to US\$50 trillion by 2050.

LDCs, LICs and LMICs have on average a credit to GDP ratio that is less than 40% (half that for LDCs), which is around half of the level in UMICs and HICs. Private sector credit in Ghana was 14% of GDP in 2010, 18% on average in sub-Saharan Africa, 30% in Kenya, and 50% in India.

Low-income countries tend to have little financial depth, hampered by low population density (in SSA), weak savings institutions, absence of pension systems, inefficient (development) banks, small stock markets with low liquidity, and financial illiteracy.

A further major challenge is the cost of financial intermediation. Private investors in SSA face additional costs of around US\$ 15 billion owing to an interest rate spread that is average 2% higher for SSA than for low and middle income countries. Competition and innovation policies that would lower the interest rate spread to the LIC and MIC average would increase the availability of finance by 1.2% of GDP and increase investment in SSA by 6%.

1. Introduction

This briefing discusses how to make domestic resources work for a transformative post-2015 agenda. We define domestic resources as government revenues and domestic private finance (or savings). Domestic resources have grown in various developing countries and groupings both compared to GDP and compared to other financial flows considered in the post-2015 context. The challenge is how to use domestic resources for a post-2015 agenda which is transformative in nature. This represents a marked change from the MDG debate which tended to assume that aid can fill gaps in social sectors, towards a post-2015 framework that aims to use the range of financial resources and non-financial means of implementation for a set of transformations (including from low productivity to high productivity, from high carbon to low carbon and from high inequalities to low inequalities). Such an ambitious agenda will rely to a large extent on mobilising and using domestic resources, although there remain special roles for aid, remittances and international capital flows.

The revised working document for the 11th session of the Open Working Group includes 16 focal areas, of which focus area 15 in Means of Implementation / Global partnership for sustainable development. It includes a set of goals related to mobilisation and effective use of domestic resources¹, by (i) strengthening domestic resource mobilisation, including by improving tax collection and the efficiency of public spending, reducing tax evasion and avoidance, improving stolen asset recovery; ensuring debt sustainability and debt relief; and promoting sustainable public procurement and (ii) strengthening systems to harness domestic savings for investment and encouraging long-term private inclusive finance. The structure of this note is as follows. Section 2 discusses mobilisation and effective use of government revenues (especially tax revenues). Section 3 covers domestic private finance. The conclusions and main points are summarised in the box on page 1.

¹ http://sustainabledevelopment.un.org/focussdgs.html#_edn144

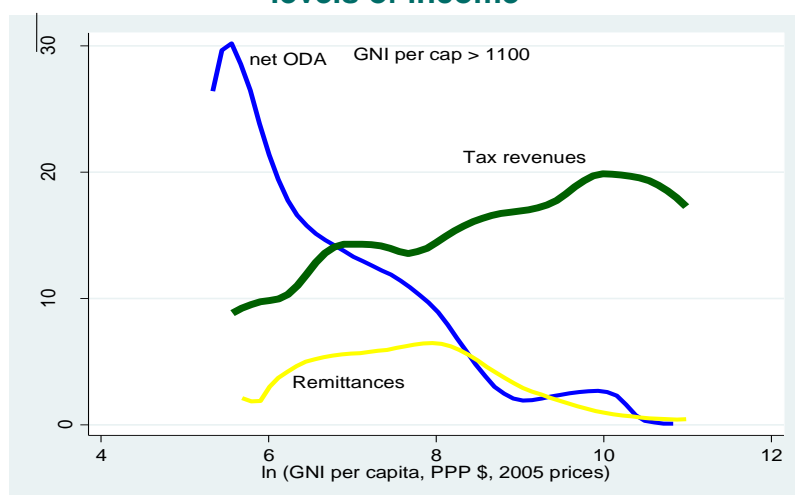
2. Domestic public finance (especially tax revenue)

Government revenues include a range of sources of finance including taxes, bond receipts² and other government income. At the most aggregated level, Figure 1 suggests that tax revenues (as % of GDP) increase with higher levels of income, to around 15% of GDP as LICs develop towards the point of graduation towards LMIC. However, there are signs of stagnation of tax to GDP ratios between GNI per capita of \$1100 and \$3000 per capita, after which it increases again to around 20%. Tax revenues tend to be greater than other flows such as remittances, and are greater than aid for countries with income greater than \$1100 per capita (data are on a log scale).

Tax performance

Two major datasets are commonly used to describe tax performance. The IMF database is most often used by tax experts, but WDI data are more easily accessible. Figure 2 presents IMF data for 1980-2010. The tax-to-GDP ratios have been rather static over time for different country groups although this masks the buoyant performance of UMICs, the small but important gains for LICs, and also remarkable performance of individual countries. Peru increased its tax ratio from 6% to 13% over the 1990s and to around 17% recently. There are also clear differences in the tax ratio across country groups.

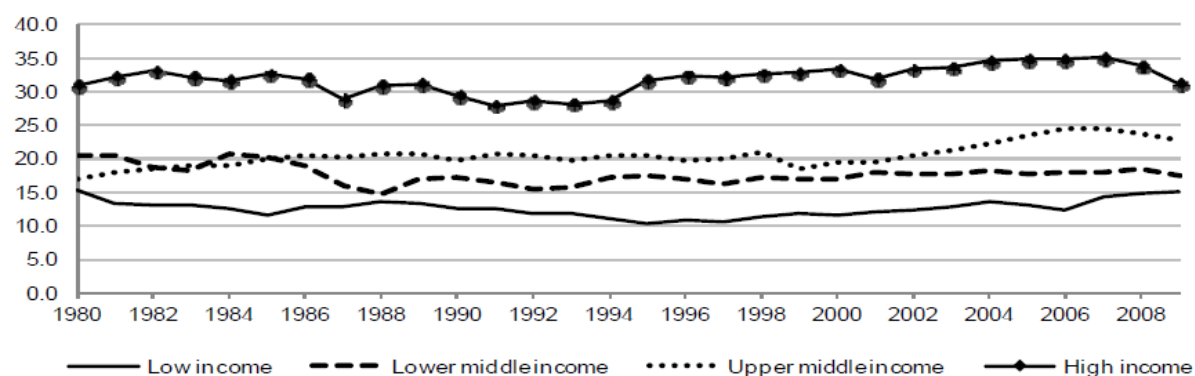
Figure 1: Tax revenues (as % of GNI) tend to grow with higher levels of income



Source: WDI (all countries, all years after 1990)

² A relatively new way for low-income and sub-Saharan African (SSA) countries to raise public funds is through issuing sovereign bonds. Sub-Saharan Africa issued a record US\$4.6 bn in 2013 in sovereign bonds (5% of developing country sovereign-bond issues), up from zero in 2010 (and around \$ 1 bn in 2001). Sovereign-bond inflows in SSA were equivalent to 12% of FDI inflows and 20% of aid in 2013.

Figure 2: Figure 2 Tax revenues (as % of GNI) by country groups



Source: IMF (2011)

The above databases do not provide values of tax revenues, so we need to estimate this. For example, World Bank (2013) suggests “domestic revenues mobilization of emerging and developing economies amounted to US\$7.7 trillion in 2012, having grown by 14 percent annually since 2000.” Provisional estimates for the European Report on Development 2014 suggest that in real terms (2011 prices) “Tax revenues have increased 407%, from \$809 bn in 1995 to \$4,107 bn in 2012”. For LICs “tax revenues have seen rising levels of tax revenues (from \$20 billion in 1995 to \$60 billion in 2012)” owing to economic growth rather than increased tax-to-GDP ratios.

The average fiscal revenue-to-GDP ratio (without grants) in **sub-Saharan Africa** (SSA) was around 20% of GDP in 2010 (IMF, 2012), but many low-income countries (LICs) have a tax-to-GDP ratio of less than 15. While varying across countries, more-developed countries have a higher revenue ratio. **Resource-rich** SSA countries have performed better in terms of tax collections compared to non-resource-rich countries, but revenues are more volatile from year to year (Keen and Mansour, 2010). **Fragile states** are less able to expand tax revenue as a percentage of GDP and any gains are more difficult to sustain (IMF, 2012). After conflicts, as economies are rebuilt, there can be good progress in developing effective tax systems, e.g. Liberia (with taxes growing from 10.6% of GDP in 2003 to 21.3% in 2011) and Mozambique (10.5% of GDP in 1994 to 17.7% in 2011) (IMF, 2011).

There are a number of dynamic trends across tax-types. Since 1980 (as a ratio of GDP), **VAT** revenues have increased (four out of five countries in SSA have a VAT, which typically raises about 25% of all tax revenues), **personal income tax** (worth around 1-3% of GDP in developing countries, compared to 9-11% in OECD) has remained static, **corporate income taxes** (responsible for around 17% of total taxes in developing countries, compared to 10% in OECD) have increased and **trade tax receipts** have fallen (as a result of trade liberalisation). **Property and land taxes** are relatively effective local taxes, but tend to be underutilised in developing countries (in percentage terms OECD countries collect 3 times as much compared to developing countries).

Improving tax performance

The IMF (2007) finds that there is a range of general and structural factors behind an economy’s **revenue performance** (or tax-to-GDP ratio). These include per capita GDP, share of agriculture in GDP, trade openness, foreign aid, and political stability. The tax base, which will underpin any sustained increase in the tax-to-GDP ratio, is driven by employment and earnings in the formal economy (the income-tax base) and private spending (the indirect tax base) (Morrissey, 2013).

It is possible to achieve short-term changes in the tax revenue ratio. About 16 of 28 LICs in sub-Saharan Africa were able to raise revenue ratios by five percentage points of GDP or more in at least one three-year period in the last 20 years. The IMF (2012) suggests that significant **additional revenue can be raised** in many developing countries by:

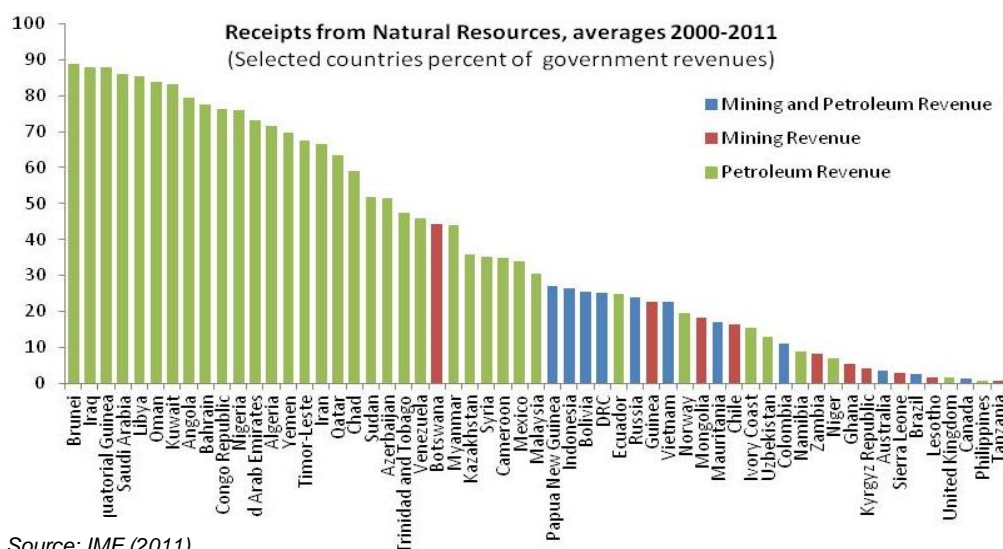
- building administrations that limit incentives and opportunities for rent-seeking and inappropriate behaviour, and that can ensure the compliance needed to extend the tax base
- adopting effective laws and regulations for to protect taxpayers
- eliminating exemptions that forgo revenue to little useful purpose
- implementing a broad-based value-added tax (VAT) with a fairly high threshold
- establishing a broad-based corporate income tax (CIT) at rates competitive by international standards
- extending the base for personal income taxes (PIT)
- levying excises on a few key items that are appropriate to revenue needs and wider social concerns
- implementing simple, but coherent regimes for taxing smaller businesses
- strengthening real-estate taxes (with potential to transform local government finance)
- developing capacity for tax expenditure and wider policy analysis

Administrations are often under-resourced, resources are not effectively focused on areas of greatest impact, and middle-level management is weak. Domestic and customs coordination is also poor, which is especially important for VAT. Weak administration, poor governance and corruption tend to be associated with low revenue collections (IMF, 2011).

Specific tax revenue and spending challenges

A wide range of instruments are used in raising **revenue from the extractive industries** (production sharing, auctions, government participation, income tax, VAT import tariffs, withholding taxes, surface fees and others). Governments commonly retain one-third of the rent from mining. IMF estimations suggest higher government shares (40-60%) in mining and 65-85% in petroleum (figure 3).

Figure 3: Government Revenue from the Eis, 2000–11



The Source: IMF (2011)

taxation of EIs is affected by a number of **specific factors**. Rents can be large, but the circumstances are highly volatile (e.g. due to volatile resource prices) and uncertain (i.e. difficult to predict). The extraction and operation of mineral resources require large initial investments, or sunk costs, while revenues accrue over time. This means there will be higher risks for a private investor whose returns will depend on government policies over a long period. This problem can lead to 'hold-up' or low levels of investment. Furthermore, EIs often depend on a few institutions and are characterised by asymmetric information issues, weak state capacities and dispersed market power, making for challenging state–business relationships. This tends to involve multinationals that can use international operations to shift the tax base. Finally, natural resources are scarce and non-renewable.

Tax administrators face a range of further challenges such as **transfer-pricing abuse, reported value of production, debt payments, and hedging**. Global discussions can tackle these challenges, e.g. through the design and implementation of transfer-pricing principles. With OECD support, transfer-pricing adjustments made as a result of audits of MNCs have increased revenues in Colombia by 76%, from US\$3.3 million in 2011 to US\$5.8 million in 2012. Donors provide further assistance, such as through the Extractives Industries Transparency Initiative (EITI) to improve transparency regarding taxes paid by EI companies.

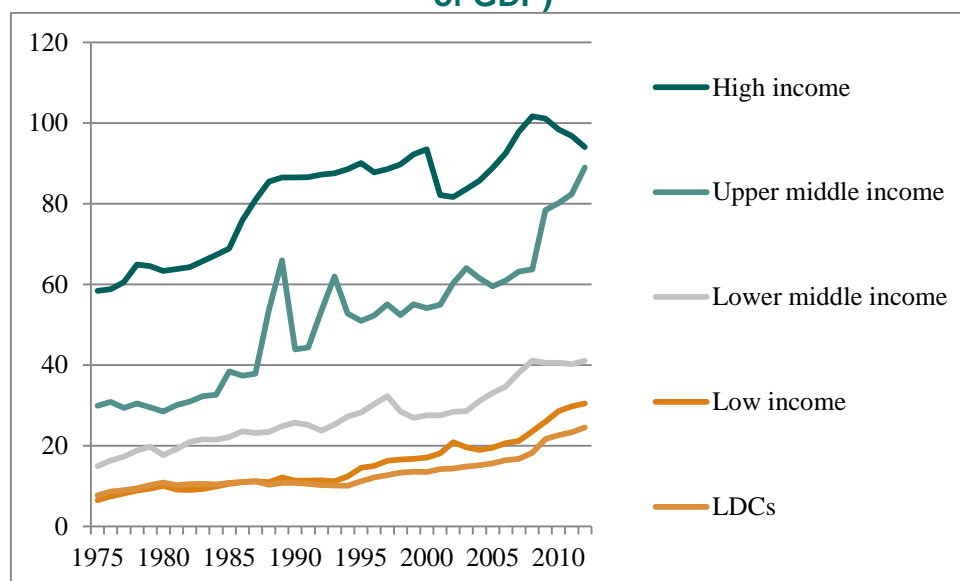
ERD (2011/2012) argues that subsidies for natural resources (e.g. for fossil fuels) are often poorly applied (with those living in poverty suffering most), are economically inefficient and are bad for the environment. Through **public subsidy reform**, public resources can be mobilised and spent more effectively (World Bank, 2013). A further issue that can make more use of existing resources is through better **public procurement**.

3. Domestic private finance

A second major challenge for domestic resources, identified in the OWG, is the mobilisation and effective use of **private savings and finance**. Often the main challenge with domestic private finance is not the level, but the lack of attention of private finance for SMEs or long-term objectives such as (green) infrastructure. There are several ways to measure domestic private finance. Here we examine two indicators: banking credit to the private sector and pension funds. Private resources from domestic pension funds and insurance companies in developing countries grew ten-fold from 2002-2012 to US\$5.5 trillion in 2012 (World Bank 2013). They are expected to increase further to US\$50 trillion by 2050.

Figure 4 shows that LDCs, LICs and LMICs have an aggregate **credit to GDP ratio** of below 40% (25% for LDCs), which is around half the level seen in UMICs and HICs. Private sector credit in Ghana was 14% of GDP in 2010, 18% on average in sub-Saharan Africa, 30% in Kenya, while 50% in India.

Figure 4. Domestic credit to the private sector through banks (% of GDP)



Source: WDI

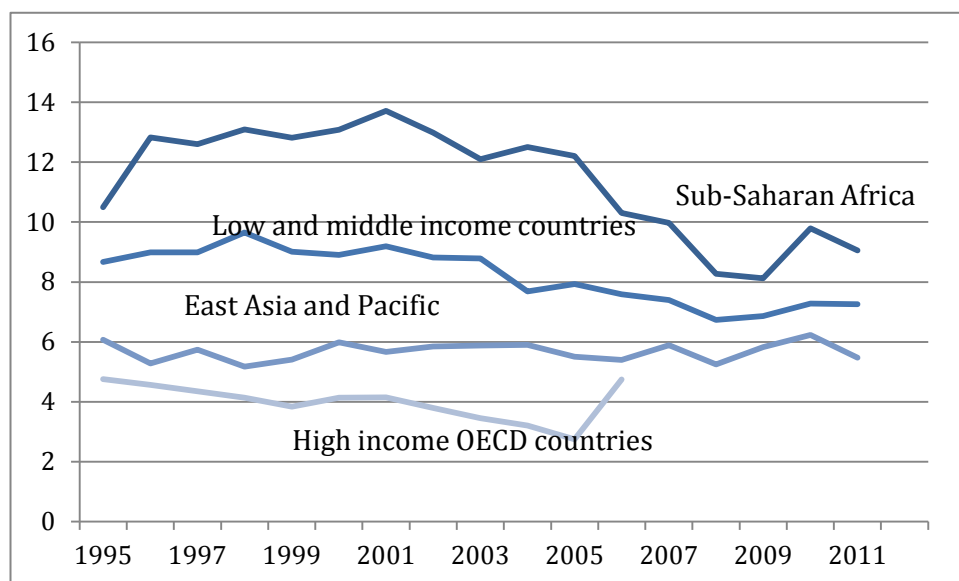
The availability and low-cost access of domestic private finance are important for bringing about transformative changes. There is an emerging literature on the **factors behind financial sector deepening** (Beck, 2013). Low-income countries tend to have little financial depth, hampered by low population density (in sub-Saharan Africa), weak savings institutions, absence of pension systems, inefficient (development) banks, small stock markets with low liquidity, and financial illiteracy. All such (non-financial) issues, many of which are related to market failures, affect financing for structural transformation.

An efficient financial system helps (1) an efficient exchange of goods and services; (2) the pooling of savings from many individual savers and overcoming investment indivisibilities; and (3) a reduction in screening and monitoring costs, agency problems, and liquidity risk. There is a large literature on the link between **domestic private finance and growth**. The early evidence suggested that an expansion of the (domestic) financial sector is correlated to growth (King and Levine, 1993) though productivity increases (see Beck et al., 2000). Recent research shows, however, that this may not hold for high levels of financial-sector development because if it is too large or expands too quickly it may lead to crises, which undermine growth (Arcand et al., 2012). Aghion et al. (2005) argue that the impact of finance on growth is strongest among LICs and MICs but fades as countries approach the global productivity frontier.

There are several policy factors that can mobilise and make better use of private domestic finance. The broad development of a **financial infrastructure** is important, e.g. developing a good regulatory framework for pension funds, insurance funds, and stock markets, all of which are likely to grow fast in LICs in the future. Better policies for developing collateral, e.g. land-titling and credit bureaux, will also develop domestic finance.

A further major challenge can be the **cost of financial intermediation** (the OWG has also discussed the cost of remittances). The costs of intermediation depend on a range of factors such as (i) individual bank specific factors such as administrative costs (ii) banking sector specific factors such as the degree of competition or regulatory requirements (iii) macroeconomic factor such as GDP or fiscal policy. The lack of an effective competition regime and incentives to innovate prevents competition amongst banks in LICs which can lead to inefficiency, high intermediation costs leading to a high interest rate spread – the gap between central bank rates and the lending rate of commercial banks. A high spread means higher costs of credit, which stifle investment with direct negative repercussions for the depth and breadth of financial systems, including lower levels of bank lending.

Figure 5 suggests that **interest rate spreads in sub-Saharan Africa have consistently been two percentage points higher than the average of LICs and MICs** (note: there are differences in definitions used across countries although some is cancelled out as they are likely to affect both borrowing and lending rates). Access to credit for the private sector in SSA stood at 61% of GDP in 2012 (or US\$ 759 billion). Private investors in Africa therefore face additional costs of around US\$ 15 billion owing to a 2% higher interest rate spread than is average for low and middle income countries. Competition and innovation policies that would lower the interest rate spread to the LIC and MIC average would increase the availability of finance by 1.2% of GDP and increase investment in SSA by 6%.

Figure 4: Interest rate spread by region 1995-2011

Source: WDI data: the interest rate spread is the interest rate charged by banks on loans to private sector customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. The terms and conditions attached to these rates differ by country, however, limiting their comparability.

References

All references are contained in:

- PEAKS course on tax revenues, see <http://bit.ly/Q9jfXh>
- DEGRP essays on the role of the financial sector in structural transformation, see <http://bit.ly/1gZbqZZ>
- Preparation for the European Report on Development 2014 on the role of finance and other means of implementation for a transformative post-2015 agenda