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Innovative Approaches to Domestic Resource Mobilization in Selected LDCs

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BACKGROUND

This is a discussion paper prepared for Expert Group Meeting on resource mobilization for poverty eradication in the Least Developed Countries which was held in New York from 19-20 January 2004.

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Introduction

Mobilization of domestic resources in recognized as the foundation for self-sustaining development. Domestic resources are important in financing domestic investment and social programmes, which are essential for economic growth and for eradicating poverty. Financing for economic growth and poverty reduction is one of the challenges facing the least developed countries (LDCs). [1] Due to inability of domestic resource to meet the financing requirements, these countries have resorted to external sources to finance development projects and social programs. However, domestic resource mobilization can be managed more innovatively for greater effectiveness. In this context, a sound fiscal policy, responsible social spending and a well functioning and competitive financial system are the crucial elements for economic and social development.

This paper examines innovative approaches to domestic resource mobilization in selected Least Developed Countries. It covers various aspects of domestic resource mobilization with focus on the linkages to poverty reduction and growth. The areas addressed in this paper include: financial sector reform policies for growth and poverty reduction, Microfinancing, taxation for growth and poverty reduction, management of domestic debt, government spending targeted to crowd in private savings and investment (including public-private partnerships), and mobilization of private capita, including reversal of capital flight and more innovative and active participation in the international trade.

Financial Sector Reforms for Growth and Poverty Reduction

Financial system is the system of institutions and operations that channels the financial resources into productive use through a process known as financial intermediation. The system mobilizes resources from the ‘surplus spending’ economic agents and makes these available to ‘deficit spending’ economic agents for productive use. Most LDCs, economies are characterized by dual systems running parallel – monetized and non-monetized; formal and informal systems. On the one hand is the money economy where transactions predominantly take place with money as a medium of exchange and on the other in the non-monetized rudimentary economy where the subsistence economy and barter dominate. The other kind of dualism refers to the formal financial system with the banks and other formal financial intermediaries as distinct from the informal system made up mostly of various shades of rotating credit systems and moneylenders. The poor, who form the largest part of population in LDCs, usually operate in the non-monetized system and/or the informal financial system.

Overall, most LDCs have achieved reasonable stability in key macroeconomic variables including inflation, growth and exchange rates. Considerable progress has been made in both economic and political liberalization, resulting in improvements in macroeconomic stability and governance. However, concern has been raised over the tight and constraining monetary and financial policies coupled with incomplete and shallow financial sector reforms.

The Least Developed Countries had poorly developed financial systems, which were among the key areas for restructuring during the Structural adjustment period. Financial sector reforms involve institutional restructuring, enhancement of legal and regulatory framework for banking operations, and interest rate liberalization.

The shift from centrally planned and administratively run economies to market has not been complete as yet. The transition has turned out to be longer than had been anticipated. The fact that a market economy requires appropriate institutions to make markets work efficiently and in the desired direction has become more explicit in the course of time. Institutions facilitate information about market conditions, they determine and enforce property rights and they influence competition in markets. The situation on the ground indicates that there are many cases where the existing institutions in LDCs are not effective in facilitating markets, including financial markets, to work efficiently with a view to promoting private investments for growth and employment creation. The effectiveness of the existing institutions is hindered by the lack of complementary institutions (missing institutions) and deficiencies in existing institutions in terms of capacity and orientation. The absence of strong governance institutions and structures at the level of government as well as the private sector continues to be of serious concern.

While developing countries are suffering from low savings and low investment the banks that have been mobilizing deposits are experiencing problems of excess liquidity. There is need to bridge the gap between low investments and excess liquidity. This situation suggests that the financial sector reforms are still largely incomplete.

The financial sector in the region has been undergoing reforms. Some positive economic growth effects have been experienced from these reforms. The financial sector remains largely shallow and narrow in terms of the financial products it offers. For instance, in aggregate terms domestic credit provided by the banking sector is on 10.1% in Tanzania and Uganda and 45.6% of the GDP in Kenya[2]. The average of Sub-Saharan Africa is barely 47.2%. These figures are low when compared with 120.4% in East Asia. However, the private sector is concerned abut the narrowness of financial products that can be accessed by the private sector and the wide spread between the high interest rates charged on loans and the low interest rates offered on deposits.

The financial sector has remained largely ineffective in mobilizing savings and assisting investors to utilize domestic resources more efficiently and effectively for poverty reduction for reasons such as limited banking networks, the long-standing problem of non-performing assets, the low level of monetization of the LDC economies and weakness of corporate governance coupled with the challenges of supervision and enforcement of prudential guidelines by the Central Banks.

In short, the financial markets remain largely shallow, narrow and inefficient. As a consequence, there are glaring gaps development finance and in financing for agriculture and small and medium enterprises. One of the core problems of domestic resource mobilization in LDCs is the fragmented nature of financial markets operating in formal and informal sectors. There is great potential for saving mobilization and channeling them to small-scale productive activities through strengthening links between formal and informal financial markets (Nissanke, 1991)[3].

Savings mobilized in the household sector through informal financial markets are small in size per unit transaction (attracting high transaction costs) as well as short term in time horizon. This puts a severe limit to the effectiveness of informal financial markets and renders them inefficient in financial intermediation.

Development finance has been eroded during the financial sector reforms in the LDCs. There is a shortage of development finance, a problem which is relatively more acute for small and medium size enterprises and for agriculture.

Access to agricultural credit in particular, constitutes a serious constraint in all LDCs, since agriculture is regarded as a risky activity by banks. During the period of policy reforms there has been retrogression on two fronts: first, agricultural development banks have either been restructured or disbanded and their lending activities rolled back; second, the restructuring of cooperatives has had a disruptive effect on lending to agriculture, especially for inputs. In particular, smallholder farmers find it extremely difficult to acquire institutional credit because of lack of collateral and dependence on irregular climatic conditions. Other forms of credit such as producer and marketing cooperative loans have declined with the reorganization of marketing cooperatives in the region. The emerging attention towards purely financial cooperatives known as Saving and Credit Cooperatives (SACCOs) and credit unions is promising but it has a long way to go.

Unfortunately, in most LDCs, these reforms have not adequately worked for the poor. Zellar and Sharma (1998) carried out a survey in nine countries including 5 from Africa, and found that the poor have rejected the formal financial sector and resorted to services from the informal financial sector due to various constraints they face in the formal setting. The study found that:

- A large number of poor households in developing countries experience real constraints in the financial market due to unfavourable prevailing transaction terms
- Because the cost of failure can be high at extremely low incomes, poor households are likely to be risk averse and sensitive abut the projects they choose to finance. Access to credit may enhance their capacity to bear risks and therefore indirectly foster technology adoption and asset accumulation.
- Poor households in Africa and Asia face complex, multiple constraints on earning opportunities. They lack education, markets, and other essential services. Thus the

impact of financial services on welfare is likely to vary with accessibility to complementary inputs such as irrigation, education, and market services.

Apparently, financial market reforms have concentrated on the formal financial systems without inclusion of services to the rural poor.[4] In the case of financing agriculture, for instance, market liberalization resulted in the winding up of marketing institutions such as cooperatives which had been instrumental in facilitating financing agricultural inputs and marketing of outputs. This type of market liberalization resulted in withdrawal of state-owned bank and government sponsored financial institutions from direct service provision to smallholders. The new private banks which were established with financial liberalization have generally shied away from financing agriculture and especially smallholders. In this context, these reforms led to the reluctance of most commercially oriented banks to engage in business involving smallholders. This brings to the fore the need to create new means of channeling seasonal inputs to smallholder producers on credit against the background of high administrative costs and defaults among small borrowers. Because of limited access to financial services the assets of most households are held in forms which can hardly be used as collateral for accessing credit for investments. A large share of savings are held in commodity stocks, houses on land without title deeds, livestock and other non-monetary assets.

Innovative approaches to resource mobilization will entail more concerted efforts towards financial sector reform. The thrust of the strategy and actions here is to ensure that financial markets work. Measures should be taken to evolve a sound financial sector that enables enterprises to enter the market and operate effectively as well as help to restructure firms to operate efficiently in competitive national, regional and global markets.

The approach to be adopted should focus on two areas: reducing the risk associated with lending; and providing incentives for financial institutions to diversify financial products in order to cope with the investment and operational requirements of businesses and households.

In pursuit of these two areas of focus, the following actions will be taken:

- To build capacity to meet the requirements of banks and access loans, especially for the micro, small and medium size enterprises (MSMEs). Appropriate investment in education and training will be undertaken to enable needy enterprises including farms access credit.

- To build the capacity of potential investors to come up with fundable/bankable projects. Advice on feasibility studies and project writer-up is needed in order to reduce the gap between banks and investors.
- Developing closer links between formal and informal financial markets deserves high priority in resource mobilization initiatives. Closer integration of these markets would enable banks to lower the costs of information and develop innovative community based contract enhancement mechanisms. This could be done by encouraging formal financial institutions to mobilize deposits and allocate credit through informal and community based banks and micro finance agents in areas where the reach of formal banks is limited. However, fiscal policies and regulation and supervision systems will need to be designed to encourage these developments.
- To promote and develop SACCOS so they can spearhead savings mobilization and effectively provide the linkage borrowers and higher-level financial institutions. This will entail encouraging banks to improve their service to MSMEs by syndicating small loans with SACCOS and community banks promoting resource mobilization and financial intermediation. There is a need for a legal framework that would prompt SACCOS to establish links with locally based financial institutions such as community banks and other credible MFIs. Such a legal provision would provide for an expanded outreach of financial services, especially increased access to credit to small-scale farmers and MSEs. However, improvement in SACCOS internal control systems, procedures and MIS are also required a priori. This is a important step towards the existence of a two-way traffic (savings and credit) between the SACCOS and banks or other thrift institutions. Action will need to be taken top establish community banks and SACCOS as autonomous to the localities they serve could from an important network of rural banks with functional procedures determined at the national level with each bank operating at a scale determined by the local economy.
- To introduce and develop guarantee schemes whereby business associations including farmer associations would guarantee some loans to the enterprises and businesses operated by their members and which are deemed credible. Initiatives should be taken to facilitate small businesses to form consortia, which can help to guarantee their members

to access, credit. Business associations including farmer associations should be facilitated to develop the capacity to undertake this function.

- To promote development financing to spearhead national and regional investment financing. Development financing institutions need to be revived but in a different context taking full account of the changed environment of a competitive market oriented and private sector-led economy. There is need to diversify financial instruments and products available for financing productive investments. In particular, the development of capital markets, leasing activities, venture capital, bond markets, securitization (structured finance), derivatives (financial contracts whose value is derived from the value of another asset), factoring (a form of receivables finance) and microfinance are some of the instruments which can be developed to fill important gaps in the existing financial system. Action should be taken to restructure and recapitalize existing development financing institutions to enable firms to make long term investments. However, these would be geared to operating in a competitive environment.
- To put in place a solid financial infrastructure (including credible information collecting and sharing mechanism) and adequate human capacity (for example in risk assessment, credit appraisal, due diligence, etc.).
- The fundamental problem of high risk and high transaction costs needs to be addressed in a programme of financial development. Action should be taken to build local capabilities in risk and asset/liability management (e.g. through risk sharing and credit risk insurance schemes). Risks associated with foreign exchange earnings, terms of trade and market access are relevant in this context too.
- Risk management encompasses development of trust and policy credibility as well as instructional and governance procedures. Macroeconomic risks can be reduced by pursuing sound macroeconomic policies, improving coordination between fiscal and monetary policy and management of government borrowing. Market risks can be reduced by improving capital market efficiency, reducing interest rate volatility and developing secondary markets for treasury bills and improving liquidity management by governments. Microeconomic risks can be reduced by improving the accuracy, reliability

and timeliness of financial information, enforcing financial contracts, having an efficient and reliable payments system and enhancing diversification in small markets.

- The cost of borrowing can be reduced by taking measures to establish and develop credit rating agencies, ensure closer supervision of financial institutions and improving the enforcement of existing reporting standards and disclosure requirements. Encouragement of the development of credit rating agencies stands out a one of the possible options that would help reduce risk and check the high lending rates charged by the financial intermediaries in the country. This is because the credit rating agencies will help the financial intermediaries overcome asymmetric information and its attendant problems: adverse selection (a phenomenon under which the potential borrowers who are likely to be bad risks are the ones who most actively seek and get loans); and, moral hazard (risk that borrowers might divert loans and thereof lower the probability or repayment). Equally important, credit rating agencies would help de-emphasize the high importance attached by financial intermediaries to track record, a requirement that results from mistrust and lack of information about potential borrowers.
- To establish and promote venture capital funds more widely so as to enable new businesses especially by the educated youth to be started and developed.
- To develop capital markets and non-bank financial institutions. Capital markets should be revitalized to enable them raise larger amounts of finance for companies. Action needs to be taken to introduce institutional procedures and mechanisms to create confidence on the part of investors. Financial sector governance and corporate governance will need to the improved especially regulation and supervision, transparency and contract enforcement. This could entail improving the conduct of public companies, disclosure requirements and shareholders' rights.
- Small savings should be mobilized through collective investment schemes (CIS). Development of collective investment schemes should be promoted – directly or indirectly in order partly to open up investment opportunities for the small-savers and partly increase mobilization of domestic savings. In tandem regulatory framework for the CIS should be developed.

- Mechanisms should be instituted to link the emerging domestic capital markets with regional and international capital markets by reducing controls and strengthening institutions (Murinde, 1999).[5]
- Institute mechanisms to improve financial services including supporting the establishment credit rating bureau.
- To promote of financial discipline and good business ethics with regard to loans. In this regard, Central banks need to be reformed in order to make them better at bank regulation and supervision. To the extent possible regional monetary authorities could be created as they stand a better change of enjoying greater independence and credibility than national central banks.
- To encourage central banks to the growth, efficiency and geographical spread of development finance institutions. This could be achieved through providing some equity capital or through creation of a conducive environment for existing financial institutions to diversify the products they offer.
- Instruments and institutions operating in the informal financial sector need to be integrated into the formal ones by adopting the legal, regulatory and institutional framework accordingly.
- The small size and limited diversity of many LDC economies suggest that a regional approach to resource mobilization is needed to increase competition, lower transaction costs and lower risks involved in financial sector development and other forms of domestic resource mobilization.

For a more inclusive resource mobilization approach, there is a need for policies that recognize the position of the poor in the LDCs, bearing in mind that these form the majority of the population in these countries. In particular, greater attention needs to be paid to the following issues:

- The poor need financial services to help them maintain and improve livelihoods. Innovations that address the constraints faced by the poor due to an imperfect financial market can allow them to take up direct income generation, increase productivity of existing enterprises, and help smoothen consumption and cope with life cycle needs.
- Both informal (including self-provision) and formal providers can help meet these needs.

- Understanding the existing financial service, behaviour and preferences of the poor can be a good guide to product design and development by other agencies.
- Financial service innovations for the poor need to be dynamic, context-specific and adapt to the changing needs.
- Providing poor people with effective financial services helps them deal with vulnerability and can thereby help reduce poverty. However, the relationship is driven by complex livelihood imperatives and is not simple. Therefore, it is not a panacea that converts the poor into the non-poor.
- Policies and programs, which target the poorest of the poor under micro finance institutions, must market financial products suitable for this category of people and reduce entry barriers faced by them.
- Credit alone may not help in poverty reduction (insurance, pension) and non-financial (technological inputs, extension, etc.) services may be needed as complements to poverty reduction. For the extremely poor sections of society, more often than not, microfinance programmes may need to be complemented with social welfare programmes in order to make a different in poverty reduction.
- Encourage microfinance institutions to provide other financial services such as insurance and pension schemes for the poor. But such services must be provided in partnership with formal sector operators. Government must create a favourable legal framework for the operation of these services.

Microfinancing

The economically active poor people in the Least Developed Countries run profitable micro and small businesses. Micro-entrepreneurs have shown that they repay market-based loans, and use the proceeds to increase their assets, their living standards and their roles in shaping societies. In many LDCs, NGOs, other specialized financial institutions and some banks have shown that microlending can be a profitable business. Microfinance can therefore provide an excellent avenue for mobilizing the domestic resources in these countries, which could finance domestic investment for growth and poverty reduction in turn. Financial services to low income entrepreneurs may be the single most effective way to reduce poverty and achieve broad-based economic growth. Yet, in the Least Developed Countries, only a small percent of low-income entrepreneurs and producers have access to financial services from sources other than moneylenders. The formal financial services in these countries are heavily biased against micro-enterprise financing. It is therefore important for the LDC governments, financial intermediaries and funders to adopt new paradigms and take on new roles in building financial systems that work for the majority.

Client-friendly savings mobilization services can be as important as loan services to micro-enterprises. Deposit mobilization can be one of the most effective means for intermediaries to mobilize resources. Savings mobilization makes financial institutions accountable to local shareholders. All financial intermediaries that lend to micro-enterprises should be encouraged to build saving mobilization arrangements for their clients, either by providing these services directly, or by making arrangements with another financial institution. Banking regulations need to be adopted to encourage those microfinancing institutions with the capabilities to legally mobilize savings from clients or the general public.

At the same time, it is important to recognize that not all institutions that are good lenders will be good at savings mobilization. Specialized financial intermediaries can mobilize equity, issue debt instruments, and borrow from banks as legitimate, long-term means to mobilize funds for lending. Financial intermediaries that serve microentrepreneurs need to view external grant and soft loan financing as complements and catalysts for domestic resource mobilization. These external infusions are important in the start-up and build-up stages, until the retail intermediary has achieved the scale and efficiency to attract domestic resources from the general public or from institutional sources.

The micro finance industry is still underdeveloped in most LDCs. While some micro finance activities are being administered as government initiated programmes and others under NGO initiatives, most of these programmes are rather ad hoc and their reach is still small compared to the needs of micro enterprises and SMEs. Microfinance has been introduced in a number of places to enhance access to finance by the small businesses. Its effectiveness has been limited by narrow coverage and a weak and not always appropriate regulatory system.

One problem with microfinance institutions in the past is that they were often paternalistic, some were used for political ends and most were subsidized in ways which were detrimental to achieving sustainability. In the changed environment of political and economic liberalization in most LDCs, the situation is likely to be different. It is important that the LDC governments take into consideration the specific country conditions, to create conducive environment for proper functioning of microfinance institutions without being paternalistic. The key areas in this respect include: access to services (not subsidies to clients), regulatory and incentive framework, proper financing for institutions, and the use of 'second-tier' institutions where appropriate. These issues are briefly discussed below.

Provide Access not Subsidies to Clients

Although MFIs contribute to poverty eradication, they are financial in nature operating on commercial principles. It needs to be recognized that they differ very much from social welfare organizations that offer charity and grants. Pricing is one of the most important determinants for the rural and micro-finance services to become sustainable. Prices (interest rates) should be set by the micro-finance institutions themselves because as operators they have the full knowledge of their costs, the markets they serve and the competition. The increase, in number, of the micro-finance institutions operating in the rural areas, the competition and efficiency will bring down the interest rates.

Experience around the world has shown that microentrepreneurs do not need subsidies and that microlenders cannot afford to subsidize borrowers. Low-income entrepreneurs want rapid and continued access to financial services, rather than subsidies. Most microenterprise clients see the "market interest rate" as the rate charged by the money lender or curb market, which is often double the interest rate charged by microlending institutions. Subsidies often send the signal to borrowers that the money came from government or donors who regard the poor as objects of charity, and borrowers see this as a signal not to repay. Few low income entrepreneurs end up benefiting from subsidized programs, because these programs fail before they reach significant numbers.

Efficient financial intermediaries need to charge the rates of interest that would enable cover the costs of making small loans.[6] Microenterprise financial intermediaries have learned that they cannot depend on governments and donors as reliable, long-term sources of subsidized funding. Commercial banks that are forces to make small loans at rates that do not allow them to cover their costs and make some profit will devise ways to circumvent mandatory allocations, or will lend and then ask government to cover loses by claiming on loan guarantees.

Building the Regulatory and Incentive Framework

Governments have important roles to play in establishing a favorable policy, regulatory and incentive framework for microfinancing institutions. In building policies, regulations and incentives for financial institutions that serve the poor, several principles and practices are key:

- A range of institutions should be encouraged to enter and expand;
- Microfinancing institutions that meet performance standards should be allowed to operate as recognized financial intermediaries;
- Entry thresholds, such as minimum capital requirements, should be kept low enough so that specialized institutions can become part of the formal financial system;
- Supervisory and reporting requirements should be kept simple, with a focus on key performance indicators;
- Institutions lending to micro and small enterprises should be free to set their on lending interest rates; and
- Attractive incentives should be provided to these intermediaries.

Provide financing that fits the Institution

If the LDC governments are to help build financial institutions that serve the majority, they will need to adopt new funding approaches that provide and promote:

- Small amounts of grant funds for promising new entrants to finance start-up operating costs and loan portfolios over a short period;
- Capitalization for institutions that meet performance standards;
- Access to refinance from development banks and other second-tier intermediaries; and
- Partial loan guarantees to encourage the build-up of leveraged credit lines by local banks to specialized financial intermediaries. Once an institution has reached the scale and

efficiency to cover costs and manage fully commercial sources, it will be able to access international commercial funds directly and through networks.

Use of 'Second-tier' Institutions, where Appropriate

A second-tier institution is a financial intermediary or network that provides financial and institutional support services to retail intermediaries. Development banks and practitioner networks have major roles to play over the next five to ten years, as wholesalers of capitalization, refinance and institutional development support, in the following areas:

- Building an agreed set of standards as the eligibility criteria for accessing support services;
- Organizing performance benchmarking systems;
- Encouraging exchange of experience among participating retail institutions;
- Serving as a wholesaler or broker of seed funding, capitalization funds, refinance of loan funds, and institutional development support;
- Encouraging mutually advantages linkages between commercial banks and specialized financial intermediaries; and
- Helping ensure that the appropriate legal, regulatory and supervisory structures and incentives are in place.

Mobilizing Domestic Resources through Fiscal Policy

The LDCs are confronting unsustainable fiscal deficits, debt service charges and declining official development assistance, seriously affecting their development process. The major challenge for these countries dwells in fiscal measures for domestic resource mobilization through tax and non-tax instruments. The instruments should be equitable, which create minimal disincentives for economic efficiency.

Since tax revenue constitutes a large share of government revenue efficiency of taxation needs to be improved as well as efficiency of public expenditure. Steps that are being taken to widen the tax base, improve tax collection and its administration (e.g. by forming national revenue authorities) and improving public expenditures (through MTEFs and PERs) are promising and should be encouraged further drawing lessons from best practice to date.

The LDCs need to initiate tax reforms to simplify and rationalize the tax structure. The non-tax revenues include social security contributions, grants from foreign governments and international organizations, property income, interest, dividends from state enterprises, rents from government property, fines, penalties and forfeits and sale of goods and services. There should e greater emphasis on improving the level of efficiency and effectiveness of the revenue administration, strengthening the institutional framework, selection of taxes and duties which are administratively feasible and lend to realistic collections, widen the tax base and progressively integrate the “informal” sector into the mainstream of the national economy.

Design Tax System that Fosters Efficiency and Compliance

A good tax system should generate revenue increase in line with nominal growth of GDP and without frequent changes in tax rates. That makes it predictable for both the administration and the business community and other tax payers. This may be somehow difficult in LDCs, where the GDP growth may be led by a growing informal sector, which are informal and not fully monetized and therefore relatively more difficult to be reached by tax collectors. In addition, most workers are employed in agricultural and/or small enterprises in the informal sector where payment is rarely regular or book-recorded. Therefore, the major challenge in this respect remains that of capturing tax revenues from the informal sector. This aspect points to the reform of the tax system, to ensure compliance among taxpayers, and delivery of public services from the collected revenues with a view to enhancing accountability of government spending to the tax payers.

A desirable tax reform should not introduce changes in relative prices and should leave the allocation of resources undisturbed. This is achievable by broadening the tax base and keeping tax rates as uniform as possible. It should be noted however that most tax administrations lack adequate resources to function in an efficient manner whereas most of taxpayers have limited capacity to keep appropriate accounts. That has led the tax administration to opt for the least resistant businesses that are easily identifiable. These tend to be overtaxed and therefore creating avenues for inequity and incentives for tax evasion and corruption. That raises not only an issue of efficiency but also a matter of equity.

Revisit Tax Administration

Governments in LDCs need to revisit their tax administration machinery with a view to getting rid of obstacles to an efficiently functioning tax system. Weak tax administration makes it difficult to achieve the objectives of overall fiscal reform.

Tax administration reform should encompass the re-definition of fiscal relationships, and the adaptation, as appropriate, of the organizational structure of tax methods and administration procedures.

The organizational structure should be such as to enable tax administration to achieve the highest possible degree of voluntary taxpayer compliance, and to administer the tax laws efficiently, effectively and fairly, with the highest degree of integrity.

A successful tax administration reform includes among others two conditions: a political commitment and a well trained and dedicated tax staff. As regards political commitment, it is worth noting that interest groups of taxpayers may make it hard to reform a tax system that will increase (or make accurate) their tax burden. It is also important to find the appropriate incentives for taxpayers and tax administrators. These incentives should go along with measures that minimize the cost of tax compliance and establish procedures for detecting violations and electing appropriate penalties.

Simple Tax Structure

A simple and clear tax structure is one of the important elements of the tax system for mobilizing domestic resources for development. This aspect has impact both on tax administration and taxpayer’s habit. For efficient and feasible tax administration, the structure of all taxes should comprise the following common elements: low rates, few nominal rate, a broad base, few exemptions, few incentives, few surcharges, few temporary measures; and where there are exceptions, clear guidelines. This is because a simple tax structure induces better tax administration.

Diversifying Resource Mobilization by Local Governments

Local governments in most LDCs are too dependent on tax revenue, which in turn depends on local taxable base and income levels. Time has come for local governments to explore other possible non-tax sources of revenue. One alternative, which in the long run has great potential, is market-based borrowing. Local authorities should be able to issue marketable instruments (or “certificates”) which would primarily attract household savings and through which corporate sectors as well as financial institutions could also invest. Detailed modalities for such instruments can be worked out. However, the success in such ventures will be determined by the financial conditions of the particular local government. One of the first steps towards effective local government participation in capital markets would entail putting their financial houses in order. For local governments this would mean operating balanced budgets and maintaining up-to-date audited annual accounts, well-staffed account units, a highly transparent system of public accounts and the absence of corruption. Financial discipline is always necessary for any accountable economic agent, but it is absolutely a must if such agents are to attract voluntary investments from the public.

Efficient and Effective Public Spending

Mobilization of resources must go with efficient and effective spending of those resources for purposes of poverty reduction. In most LDCs government spending is allocated to region and districts according to size of population and geographical location with little consideration to poverty. There is a need to make government spending more poverty sensitive in its allocation. Allocation of public expenditures in consideration of poverty will also most likely go with greater allocation of local governments and/or greater revenue collection at the local levels. In both cases the capacity of local governments will need to be enhanced in order to cope with the decentralization of fiscal responsibilities especially because poverty considerations require that a large share of government expenditures actually take place at local government level.

An important policy induced way of mobilizing domestic resources entails re-orienting government expenditures towards areas that would crowd in private savings and investment. This involves public expenditure policies geared towards infrastructure development, communication, and human capital development. In this way public investment would crowd in private savings and investment through increased incomes and productivity, and complementarity between public capital and private capital. In LDCs, investment in rural roads and utilities would have the positive impact not only in opening up the rural economies and thereby improving the rural incomes, but also in creating a conducive environment for financial service providers to operate in these areas, thus stimulating the mobilization of resources.

In view of the changing role of the state and the need to promote private investments, avenues of public-private sector partnerships in undertaking investments need to be explored. Useful lessons can be drawn from best practices in LDCs and in other countries.

Active Participation in International Trade

Another important area for domestic resource mobilization by the LDCs is active participation in international trade. Two approaches are identified here. First, the developed country policies need to change towards facilitating market access for the LDCs. Second, LDCs need to adopt more innovative approaches to increase value added for their products in international trade.

Developed countries can help the domestic resource mobilization processes by pursuing coherent aid and trade policies that promote development. The modest increase in aid flows that was promised in Monterrey in March 2002 point to a promising reversal of the downward trends of the 1990s although its scale is below requirements for achieving the millennium goals by 2015. The effectiveness of aid will need to be improved as an important part of improving aid relationships. Challenges of market access will need to be addressed. At $300 billion per annum agricultural subsidies are 6 times the volume of ODA and trade barriers to exports for which developing countries are more competitive (e.g. textiles and clothing) should be reduced under a more competitive would trading system.

Historically, most LDCs have specialized in the production and export of unprocessed primary commodities, which are subject to market access barriers, price volatilities and declining demand in the world market. This has seriously limited the participation of LDCs in world trade. However, there is room for improvement if these countries focus seriously on value addition especially on the part of agro-products and mineral products. Therefore, LDCs could use serious export promotion measures geared towards expansion of agro-based manufactured exports, as an important strategy for mobilizing domestic resources for development financing.

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Notes:

[1] The least developed countries (LDCs) are a group of 49 countries that have been identified by the UN as "least developed" in terms of their low GDP per capita, their weak human assets and their high degree of economic vulnerability. The countries included in the LDCs group are: Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Cape Verde, the Central African Republic, Chad, the Comoros, the Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, the Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Samoa, Sao tome and Principe, Senegal, Sierra Leone, Solomon islands, Somalia, Sudan, Togo, Tuvalu, Uganda, the United Republic of Tanzania, Vanuatu, Yemen and Zambia

[2] World Development Report for 2003. World Bank, Washington D.C. 2003.

[3] Nissanke, M. Mobilizing Domestic Resources for African Development and Diversification: Structural Impediments to Financial Intermediation. In Chhibber, A and S. Fischer (Eds.) Economic Reform in Sub-Saharan Africa. A World Bank symposium , Washington D.C. 1991.

[4] Institutions in the informal financial sector, which provide services to the poor, include: deposit collectors, moneylenders, Rotating Savings and Credit Associations (ROSCAs). These informal mechanisms vary from country to country but their basic operation is to provide a means for accumulating large sums by the poor. Deposit collectors will accept people's savings and return a lump sum to them, moneylenders will provide the lump sum up front and then collect 'savings' in repayment, and ROSCAs allow people to get together and make savings from which each in turn takes a lump sum.

[5] Muvinde, V. Financial Institutions and the Mobilization of Resources for Development. In Kayizzi – Mugerwa, S. (Ed.) The African Economy: Policy, Institutions and the Future. Routledge Studies in Development Economies. London and New York 1999.

[6] In most cases, the rates are high due to high costs associated with (many) small loans.