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### Theme: "Tracking Progress on Implementing ICTs for Development in Eastern Africa"



## ENHANCING DOMESTIC RESOURCES MOBILIZATION THROUGH FISCAL POLICY



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## General considerations

The theme of “*Enhancing Domestic Resources Mobilization through Fiscal Policy*” was adopted by the 2008 Conference of Ministers of ECA as the main focus of the 2009 Conference. The present issues note by the Subregional Office for Eastern Africa is intended to serve as a basis for such brainstorming in the specific context of the Eastern Africa subregion. In this context, experts participating at the 13<sup>th</sup> ICE meeting are requested to raise issues and suggest proposals to Ministers.

1. *Inadequate economic growth*: Recent economic performance in Eastern Africa has been strong, with growth rates ranging from 5.2 percent to 6.3 percent from 2004 to 2008. Encouraging as this performance is, these rates are insufficient for these countries to reach the first Millennium Development Goal of halving poverty by 2015. Indeed, it has been estimated that growth rates of 7 to 8 percent are necessary to achieve this goal. To achieve such growth rates, countries require a significant and sustained increase in resources devoted to promoting development.

**Table 1: Eastern African Countries real GDP growth, 2001-2009  
(Change in annual %)**

	2001	2002	2003	2004	2005	2006	2007	2008	2009 (Est)
Burundi	3.2	5.6	-2.3	4.4	0.9	6.3	6.3	5.0	6.0
DR C	-4.1	3.4	6.0	6.9	6.5	7.0	7.0	7.2	9.0
Djibouti	1.5	2.0	2.5	2.1	4.6	4.2	5.0	5.0	6.0
Eritrea	5.8	-1.2	5.4	1.0	4.6	4.8	2.0	1.0	2.5
Ethiopia	7.0	7.5	3.1	12.3	8.7	5.3	9.4	8.0	7.5
Kenya	1.2	1.4	2.8	4.3	4.7	5.4	6.3	2.5	2.5
Madagascar	6.0	-12.7	9.8	5.3	4.6	5.7	5.6	5.2	7.2
Comoros	2.4	2.3	2.1	1.9	2.0	3.0	1.2	0.5	1.5
Rwanda	6.0	9.4	3.2	3.7	6.0	6.3	6.3	11.2	6.3
Seychelles	-8.1	1.2	-6.3	-2	-2.3	8.3	7.3	6.2	4.2
Tanzania	4.6	4.8	5.6	4.0	5.0	4.0	6.9	6.2	6.9
Uganda	6.4	6.9	4.4	5.6	5.6	6.2	6.0	6.0	6.6
<b>Eastern Africa</b>	<b>4.4</b>	<b>3.0</b>	<b>4.9</b>	<b>5.2</b>	<b>6.1</b>	<b>6.2</b>	<b>6.3</b>	<b>5.7</b>	<b>5.5</b>

*Source: IMF, 2008 & EIU, 2008*

2. *Ownership of development*: Many countries in the Eastern African sub-region heavily rely on foreign aid. Therefore, a focus on improving domestic resources mobilization and improving the quality of its use would not only increase the level of resources available for development and poverty reduction, it could also create the policy space necessary for countries to claim real ownership of their development processes.

**Table 2: Aid Flows, ODA net total, all donors, 2001-2006  
(USD million)**

	2001	2002	2003	2004	2005	2006
Burundi	137	172	227	362	365	415
DR C	243	1175	5416	1824	1827	2056
Comoros	27	32	24	25	25	30
Djibouti	58	78	79	64	76	116
Eritrea	281	230	316	264	355	129
Ethiopia	1104	1297	1594	1806	1910	1947
Kenya	462	391	521	654	767	943
Madagascar	374	369	539	1248	914	754
Rwanda	299	354	335	486	571	585
Seychelles	13	8	9	10	15	14
Tanzania	1264	1236	1704	1751	1481	1825
Uganda	790	710	976	1194	1177	1551
<b>Eastern Africa</b>	<b>5052</b>	<b>6052</b>	<b>11740</b>	<b>9688</b>	<b>9483</b>	<b>10365</b>

*Source: AfDB/OECD 2008*

**Table 3: Foreign Direct Investment Inflows, 2001-2006 (USD million)**

	2001	2002	2003	2004	2005	2006
Burundi	0	0	0	0	1	290
DR C	82	117	158	10	-79	180
Comoros	1	0	1	1	1	1
Djibouti	3	4	14	39	22	108
Eritrea	12	20	22	-8	-3	4
Ethiopia	349	255	465	545	221	364
Kenya	5	28	82	46	21	51
Madagascar	93	61	95	95	86	230
Somalia	-	-	-	-	-	-
Rwanda	4	3	5	8	11	15
Seychelles	65	48	58	38	86	146
Tanzania	389	388	308	331	448	377
Uganda	151	185	202	222	257	307
<b>Eastern Africa</b>	<b>1154</b>	<b>1109</b>	<b>1410</b>	<b>1327</b>	<b>975</b>	<b>2073</b>

*Source: AfDB/OECD 2008*

3. *Efforts should be made to increase investments opportunities in countries in the sub-region.* Indeed, improving the use of domestic resources to development programmes is likely to have a great and positive impact on development and generation of income for many countries. The large number of banks in Africa that have excess liquidity confirms that the problem is not only a lack of financial resources, but also a lack of suitable investment opportunities. The fact that bank's resources are dominated by short-term deposits that cannot be invested in long-term maturity projects further

restricts investment possibilities, especially investments in areas that are most needed in African countries, such as infrastructure.

4. *Fiscal sustainability*: While increasing taxes for raising domestic resources, countries should keep in mind the issue of fiscal sustainability for businesses and households. The high tax rates on firms in Africa have always been considered as a significant burden on firm growth and investment, and are a major factor in keeping firms in the informal sector. High taxes also encourage tax avoidance and capital flight. A simplified and predictable tax system should be developed that balances the profit interests of investors and revenue generation for the host country. *The key questions are whether the current course of fiscal policy will be sustained without exploding debt, or if governments will not have to increase taxes, decrease spending, or recourse to monetization.*

## 1. Fiscal Policies Trends in Eastern Africa

### 1.1 Restrictive fiscal stance

The fiscal revenue collection level in Eastern Africa is low, averaging just over 10 percent of GDP between 2000 and 2005, making the countries dependent on external budgetary assistance. However, due to its unreliability in terms of timely disbursement, reliance on external budgetary assistance has often led to high domestic borrowing. This explains also the high levels of domestic interest rates. In contrast to the poor performance of government revenue, public expenditure has on average been rising steadily from 17 percent of GDP in 2000 to over 21 percent by 2005.

**On revenue side**, fiscal strategies adopted by most governments target raising revenues substantially as a percentage of GDP in order to finance part of public expenditures. Unfortunately, many countries suffer from tax collection capacity, and to improve tax mobilization, those countries focus on strengthening tax administration, taking into consideration that there is almost no scope for raising existing tax rates without distorting resource allocation and undermining incentives for voluntary taxpayer compliance. Governments have implemented reforms to strengthen the management of tax administrations, to improve their internal systems, to enhance training of personnel and to improve taxpayer compliance.

**On expenditure side**, fiscal strategies entail maintaining strict budgetary discipline in order to minimize government borrowing from the domestic banking system which would either be inflationary or crowd the private sector borrowing. This means that governments must restrict their total expenditures to less than the sum of domestic tax and non-tax revenues and net inflows of external donor finance.

**At regional level**, regional economic communities have set up some targets of fiscal strategy.

*Within COMESA*, macroeconomic convergence criteria target harmonizing economic, fiscal and monetary policies of its member States. In that context, targets for fiscal policies were to achieve:

- 1) A maximum level of the percentage of fiscal deficit to GDP of 3.0 per cent
- 2) A limit of 10 per cent GDP of claims on the central government
- 3) A Central Bank financing of the budget deficit limited to no more than 20 per cent of the previous year's fiscal revenue, in order to harmonize limits on inflationary financing;

- 4) An increase in tax revenue
- 5) Moderate monetary expansion involving setting of periodic targets for growth of money supply
- 6) Adequate flow of credit to the private sector
- 7) Elimination of direct credit controls on banking lending
- 8) Deregulation of interest rates and progressive dismantling of interest rates ceilings
- 9) Use of indirect instruments of monetary control such as reserve requirements, changes in discount rates and open market operations, according to the stance of monetary policy.

East African Community (EAC) set up macroeconomic convergence criteria, namely:

- 1) Maintenance of low and stable underlying inflation to single digit rates of less than 5 percent;
- 2) High and sustainable rate of growth of real GDP of 7 percent as the minimal target annually;
- 3) A reduction of current account deficit to GDP ratio to a sustainable level; Reduction of budget deficit excluding grants to GDP ratio of less than 5 percent;
- 4) Raising national savings to GDP ratio to at least 20 percent in the medium term;
- 5) Building gross foreign exchange reserves to a level equivalent to 6 months of imports of goods and non-factor services in the medium-term;
- 6) Maintenance of low market determined interest rates;
- 7) Maintenance of stable market determined exchange rates;
- 8) Pursuit of debt reduction initiatives to reduce both domestic and foreign debt;
- 9) Maintenance of prudential norms of banking regulation, strict supervision, improved corporate governance and transparency of all financial transactions.

### Fiscal Development in selected countries in Eastern Africa

**Table 4: Revenue performance, 2000-2005 (percentage of GDP)**

	2000	2001	2002	2003	2004	2005
Burundi	19.3	21.7	20.5	18.0	18.1	17.1
DR Congo	5.1	6.2	7.9	8.3	9.0	10.1
Ethiopia	18.8	20.1	21.7	20.8	21.4	21.6
Madagascar	11.7	10.1	8.0	10.6	11.5	12.0
Rwanda	9.7	11.4	12.2	13.4	13.6	13.7
Tanzania	12.1	12.5	13.1	13.6	14.2	14.9
<b>Average</b>	<b>11.0</b>	<b>10.3</b>	<b>10.4</b>	<b>10.6</b>	<b>11.0</b>	11.2
Djibouti	31.0	28.2	29.4	34.2	35.0	33.5

*Source: IMF and country documents*

**Table 5: Expenditure Outturn, 2000-2005 (percentage of GDP)**

	2000	2001	2002	2003	2004	2005
Burundi	28.9	25.3	26.3	25.4	29.1	25.0
DR Congo	11.1	7.9	10.4	15.2	18.6	20.6
Djibouti	24.4	23.3	28.1	26.8	26.8	26.0
Ethiopia	5.0	15.3	16.0	16.5	17.3	17.6
Madagascar	15.9	17.6	15.7	18.2	18.3	18.5
Rwanda	18.7	21.0	23.2	24.7	21.0	21.7
<b>Average</b>	<b>17.3</b>	<b>18.4</b>	<b>19.2</b>	<b>21.4</b>	<b>21.5</b>	<b>21.6</b>

*Source: IMF and country documents*

### 1.2 Low Domestic Savings

It is generally acknowledged that savings rates in Africa, especially in Sub-Saharan Africa are lower than in any other region in the world. In Eastern Africa, savings rates range between 10 to 15 percent of GDP.

Though gross domestic savings rate in the sub-region have improved slightly in recent years, from about 5.3 per cent of GDP in 2000 to 7.5 per cent in 2005, it is still far below the average rate of Sub-Saharan Africa in 2005 of 17.6 per cent and that achieved by the African continent in 1980s of about 26 per cent (UNCTAD 2007). Gross domestic saving is a serious obstacle in reaching the goal of realizing high economic growth and significant poverty reduction, in the absence of increased external inflows. Although the rising share of gross domestic saving is encouraging, in particular for some countries such as Madagascar, Tanzania and Uganda, a lot needs to be done to stimulate savings to rise sharply.

**Table 6: Gross Domestic Savings, 2000-2005 (percentage of GDP)**

	2000	2001	2002	2003	2004	2005
Burundi	-7.4	-11.8	-3.2	-4.0	-4.4	-4.7
DR Congo	4.4	3.2	4.9	5.8	7.6	8.9
Djibouti	5.2	2.7	4.2	7.9	10.6	11.3
Ethiopia	2.6	2.2	0.5	3.5	4.8	6.8
Kenya	-6.2	6.7	12.4	5.0	3.6	-1.3
Madagascar	9.4	17.2	8.3	12.9	14.8	14.9
Rwanda	17.5	2.5	1.7	1.2	2.6	4.6
Tanzania	16.1	15.9	17.7	15.8	16.0	16.1
Uganda	6.0	8.2	9.8	9.6	10.8	11.1
<b>Average</b>	<b>5.3</b>	<b>5.2</b>	<b>6.2</b>	<b>6.4</b>	<b>7.4</b>	<b>7.5</b>

*Source: IMF and country documents*

### 1.3 Importance of workers' remittances

Workers' remittances are increasingly being recognized as important sources of finance for development. Representing about 8.1 billion dollars in 2005 (ECA 2006), remittances represent an important capital inflows, although their significance varies from country to country. They have been steadily growing and there good reasons to believe that unrecorded remittances flows that transit through informal channels are at least as important as recorded flows (UNCTAD 2007). Remittances are mainly used to meet basic needs and schooling. There is however, some investment in real estate and, to a lesser degree, in financing small and medium-sized enterprises or small infrastructure projects.

**Table 7: Workers' Remittances for 8 countries in Eastern Africa, 2001-2005  
(USD million)**

	2001	2002	2003	2004	2005
Comoros	12	12	12	12	12
Ethiopia	18	33	46	134	174
Kenya	395	494	371	524	-
Madagascar	11	17	16	11	11
Rwanda	8	7	9	10	21
Seychelles	5	7	11	-	-
Tanzania	15	12	9	11	16
Uganda	342	421	306	368	450

Source: AfDB/OECD 2006

#### 1.4 Low Private Savings

Looking at private savings, a similar development can be seen as the share of private savings has been rising but remains below 10 per cent of GDP far much below that of Mauritius, where private savings had exceeded 30 per cent of GDP. Such high rates of private savings are imperative for the economic transformation.

**Table 8: Private savings, 2000-2005 (percentage of GDP)**

	2000	2001	2002	2003	2004	2005
DR Congo	4.4	2.1	9.8	10.6	10.2	9.9
Ethiopia	0.7	1.4	-0.4	3.2	1.9	2.5
Kenya	1.2	-1.3	4.9	4.8	6.1	6.3
Madagascar	12.2	21.5	13.8	16.2	18.7	18.5
Rwanda	4.2	5.4	5.8	4.8	3.2	4.5
Tanzania	14.1	13.7	15.6	13.6	13.8	14.0
Uganda	4.9	1.7	9.7	5.5	5.1	5.5
<b>Average</b>	<b>6.2</b>	<b>7.1</b>	<b>8.2</b>	<b>8.0</b>	<b>8.1</b>	<b>8.6</b>
<i>Mauritius</i>	<i>30.1</i>	<i>29.1</i>	<i>27.8</i>	<i>24.6</i>	<i>23.8</i>	<i>22.8</i>

Source: IMF and country documents

## 1.5 Increasing Domestic Investments

In Eastern Africa, gross domestic investment to GDP has been rising from 14 percent in 2000 to almost 22 percent in 2005. Almost all countries in the subregion have recorded increasing rates of domestic investments. It is expected that gross domestic investment, as a share of GDP will continue rising and may reach 30 percent in 2015, the target year to achieve the Millennium Development Goals. The share of private investment to GDP (Table 10) has remained almost static over the period 2000-2005 despite the expressed wish of most governments to let the development of the private sector as the real engine for economic growth.

**Table 9: Gross Domestic Investment, 2000-2005 (percentage of GDP)**

	2000	2001	2002	2003	2004	2005
Burundi	8.5	8.1	10.7	11.1	14.4	14.6
DR Congo	3.5	5.2	9.0	13.5	18.1	21.0
Djibouti	12.3	8.3	10.2	15.5	20.6	29.9
Ethiopia	17.8	20.5	21.2	23.3	22.6	22.7
Kenya	15.0	14.1	14.5	17.9	22.7	25.9
Madagascar	15.0	18.5	14.3	17.5	19.4	20.4
Rwanda	17.5	18.4	18.8	19.9	20.0	20.7
Tanzania	17.6	17.0	17.4	18.9	18.9	18.4
Uganda	20.1	21.7	22.8	23.2	23.4	23.5
<b>Average</b>	<b>14.1</b>	<b>14.6</b>	<b>15.4</b>	<b>17.9</b>	<b>20.0</b>	<b>21.5</b>

*Source: IMF and country documents*

**Table 10: Private sector Investment, 2000-2005 (percentage of GDP)**

	2000	2001	2002	2003	2004	2005
DR Congo	3.0	5.1	8.0	9.5	10.5	11.0
Djibouti	9.6	5.8	6.5	-	-	-
Ethiopia	9.3	9.0	9.6	9.8	10.9	11.6
Kenya	11.4	11.6	11.0	13.1	16.3	18.3
Madagascar	8.3	11.2	9.3	10.2	11.2	11.7
Rwanda	11.6	11.8	12.0	12.2	12.4	12.6
Tanzania	13.2	13.5	13.4	13.8	13.8	13.7
Uganda	13.8	17.6	17.6	18.1	18.5	18.7
<b>Average</b>	<b>10.0</b>	<b>10.5</b>	<b>10.9</b>	<b>10.8</b>	<b>11.7</b>	<b>12.2</b>

*Source: IMF and country documents*

## **2. Key Actions for Pro-Growth Fiscal Policy**

### **2.1 Increasing Public Resources for Investment**

Public sector resources have a distinct and complementary role to play vis-à-vis private savings. Public expenditure is essential for human capital development through its funding of essential public services such as education and health provision. Public investment can provide the resources for infrastructure which are indispensable for the private sector to thrive (UNCTAD 2007). Tax revenue, which represents almost all government domestic revenue in African countries, is therefore an important factor determining the amount of resources that be used for development. In most African countries, tax revenue is low, and recent reforms have had limited impact. There are several reasons behind, in particular, weak capacity of administrations for tax collection, tax evasion by some tax collectors, corruption, etc. *How can public revenues be increased?*

### **2.2 Improving financial intermediation**

Financial intermediation provides the crucial link between savings and investment. Despite households' demands for adequate savings instruments and firms' needs for credit, the financial sector in many countries performs poorly in terms of intermediation. The formal sector suffers from poor risk-management capacity, which translates into its activities being limited to meeting the needs of Governments and a small number of formal sector firms. A large number of banks in Africa have excess liquidity; unfortunately banks' resources are dominated by short-term deposits that cannot be invested in long-term projects. *How can these resources be used for long-term investments?*

### **2.3 Promoting micro-credit schemes**

It has been noted that the informal sector succeeds in mobilizing considerable resources from households and small businesses, but its institutions do not generally make these resources available for further investment. *How to promote microfinance institutions in the semi-formal sector and enhance them with new information technologies that lower the costs of providing services to rural and poor areas?*

### **2.4 Increasing Remittances Flows**

It has been noted that workers' remittances represent a more important capital inflow than FDI, and in some countries, than ODA inflows (UNECA 2006). Remittances can have a positive impact on receiving countries in a number of ways. Firstly, as inflows of foreign capital, remittances improve the balance of payments situation of receiving countries. Secondly, remittances directly reduce poverty and help households smooth their consumption patterns, thereby indirectly contributing to stabilizing the country's economic activity (UNDP 2005). Finally, there is some evidence of remittances being increasingly used for investment purposes, mainly in financing small and medium-sized enterprises or small infrastructure projects (UNCTAD 2007). With the appropriate policies and institutions in place, they could be better harnessed as a development resource and channeled into productive investment, thereby contributing to employment and growth.

## **2.5 Promoting the Private sector Investment**

High risk and a generally poor business environment are key determinants of low investments in many African countries. Poor infrastructure discourages investment because it increases production costs. Countries in Eastern Africa are ranked very low in the World Bank Report, “Doing Business 2009”, and main barriers to private investment include: high entry costs, labour market constraints, low investor protection, high taxes and a cumbersome tax system, lack of long-term credit for investment, etc. These barriers explain why the FDI is still low in many countries in the region.