CHAPTER 4

Fiscal Policy, Long-Term Growth and Structural Transformation in Africa

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4.1 Introduction

Fiscal policy is an important macroeconomic policy tool for shaping African countries' development agenda. However, the various controversies in the literature about the effectiveness of fiscal policy as a mechanism for ensuring macroeconomic stability have been anchored on ideological differences of the protagonists. Indeed, despite the

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theoretical potential benefits and flexibility of fiscal policy, its application has been largely constrained by a range of factors: political economy, institutional as well as economic (Kararach 2011). Its overall success in driving the structural transformation agenda will have to be judged in that context.

Fiscal policy can be a strong driver of medium-to-long-term growth and structural transformation through a number of channels. It is an important means to correct market failures especially by defining micro-economic adjustments at firms and household levels. For example, fiscal policy can be used to create markets in circumstances where monopolies get charged lump-sum taxes to speed up liberalisation. Equally, taxes can be used to penalise uncompetitive behaviours by economic agents. The provision of public goods to deal with non-exclusion problems can be largely underpinned by fiscal actions.

Essentially, fiscal policy promotes structural transformation through strategic tax and expenditure interventions. At the macro level, relevant tax and expenditure interventions can ensure macroeconomic stability, an essential prerequisite for sustainable economic growth. While at the micro level, well-designed tax and spending policies define the nature of employment, investment and productivity growth. In the context of structural transformation, fiscal policy can be used to define the nature of incentives, correct distortions in the economy, shape R&D and innovation, channel investments in critical sectors such as infrastructure, promote distributional objectives such as between rural and urban areas and contribute to human capital and skills accumulation.

Given the political nature of fiscal decisions, the formulation and nature of public buy-in are critical for the success and durability of the requisite fiscal reforms. For them to be effective, fiscal reforms must be internally consistent and complemented by relevant structural policies and reforms (e.g. labour or trade) and other macroeconomic policy tools. Balancing efficiency and equity objectives and fostering public support through social dialogue are critical in defining the role of fiscal policy in the context of Africa's structural transformation agenda.

Africa's priority is not only to register positive growth but also to make this growth job-creating, equitable and inclusive. Prudent fiscal policy is required for African economies to achieve such long-term economic development and transformational objectives. But these issues need to be discussed in the context of the generally well-known "sectoral" balance relationships among private savings (S), private investments (I), imports

(M), exports (X), tax revenue (T) and government expenditure; and how these elements behave. The fiscal balance equation is of the type: $S + M + T = I + X + G$. Equally, considerations need to be given to the supply-side constraints on the economy when discussing the efficacy of fiscal policy. In the context of Africa, structural transformation has been undermined by two major sets of supply constraints: (1) capacity constraints (including insufficient capital to provide full employment and structural imbalances such as lack of electricity). In this regard, the effects of fiscal policy have to include those on productive capacity; and (2) the balance of payments constraint which its non-existence requires $X - M = G - T$. Indeed, the sectoral balance equation has been at the heart of the Great Debate on the efficacy of fiscal policy as transformative tools and is not the focus of our discussions in this chapter (or book).

This chapter discusses some key elements of fiscal policy such as revenue mobilisation, expenditure and fiscal management necessary for delivering growth and equity objectives, improving the efficiency of the existing fiscal system and structural transformation of the continent. It highlights issues that attention must be paid to including but not limited to problems of illicit financial flows, corruption, informality, poverty and social protection and management of natural resource rents. The chapter is organised as follows: Section 4.2 discusses the experiences and importance of revenue/resource mobilisation for African countries. It is argued in the section that expanding Africa's fiscal space is critical for the delivery of its structural transformation agenda. Section 4.3 examines the criticality of public expenditure in the continent's pursuit of both macroeconomic stability and long-term growth and transformation. Section 4.4 focuses on how to shape long-term growth and transformation through fiscal policy management. Section 4.5 concludes the chapter.

4.2 Boosting Government Revenue with Proper Incentives and Tax Structures

As part of its structural transformation agenda, it is critical that African economies efficiently mobilize both public and private sources of finance, while adapting to the demands for macroeconomic stability and long-term development. Sources of shocks such as climate change and commodity price volatility raise issues that have implications for the design of national tax and spending systems. As an example, strong fiscal buffers and good

infrastructure are critical for any response to natural disaster risks. Equally, boosting government revenue is central to making clean investments and pooling climate-related risks. African countries must therefore design effective incentives and tax structures as core pillars of fiscal policy for structural transformation, especially to ensure job-based growth (Kararach 2011, 2014).

4.2.1 Stylized Facts on Taxation in Africa

To make the right fiscal policy choices, African countries need to have a good understanding of the stylized facts that characterized their tax systems. The African Economic Outlook for 2013 provides a very helpful summary of these stylized facts. First, the trend of tax revenues on the African continent is positive, with the average tax revenue as a share of GDP or the tax ratio increasing since the early 1990s. Collected taxes average for Africa increased from 22 per cent of GDP in 1990 to around 27 per cent in 2014–2015, suggesting many economies made progress in collecting taxes. Fig. 4.1 provides trends for select economies from the four regions of the continent based on data availability for 2000–2012, with most of the countries showing improvement in collection.

It is apparent from Fig. 4.1 that any averages hide the huge differences in the performance of individual countries. Classifying African countries

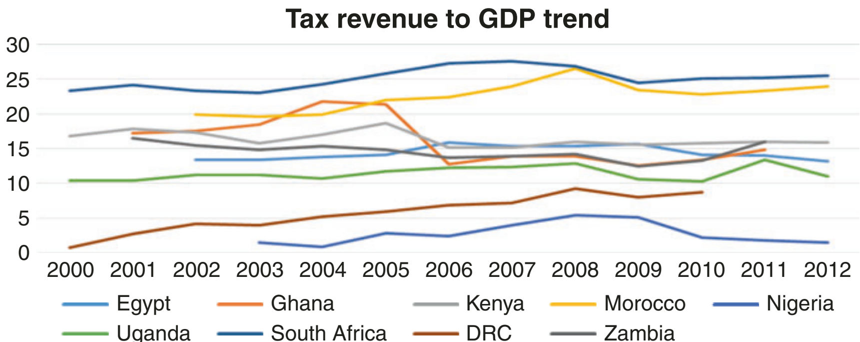

Fig. 4.1 Tax-to-GDP ratio for select African countries (2000–2012)

Source: ECA staff computation

with respect to their level of income exhibit three different trends in tax ratios (AfDB et al. 2013). It is reported that the tax share for upper middle-income countries is similar to the tax share of OECD countries of about 35 per cent of GDP (OECD 2009).

Second, tax per capita for Africa has also risen due to enhanced collection, although the increase has been modest in low-income countries. Taxes per capita indicate the amount of tax revenue collected on average by government for each inhabitant. It is also the amount of tax money available to government to spend on average for each inhabitant in the provision of essential services. Equally, large differences exist across African countries in the per capita levels of tax revenue. The data for 2000–2012 shows that for countries such as Burundi, the Democratic Republic of Congo (DRC), Ethiopia and Guinea-Bissau, annual per capita taxes are as low as USD 11 per head. While in countries such as the Seychelles, Libya and Equatorial Guinea, taxes per inhabitant are as high as USD 3,600 (AfDB et al. 2013).

Third, the tax mix in Africa is also wide-ranging. The tax mix shows the particular purpose for which a tax is imposed as well as its welfare effects. For example, South Africa gets most of its tax revenues from direct taxation, especially income, profits and capital gains, unlike countries such as Senegal and Uganda that depend on heavily indirect taxation (Fig. 4.2). By contrast, Kenya, the DRC and Ghana have a blend balancing different types of taxes. Others, such as Algeria, Angola, Equatorial Guinea, Libya and Nigeria rely on a single type of tax. The countries that depend on single tax type tend to be mono-commodity exporters such as oil and other natural resources. It is noticeable that such economies are vulnerable to commodity price volatility (Kararach 2017).

Direct taxes share of GDP has experienced a small increase across Africa in the last decade or so, especially in upper- and middle-income countries such as Botswana, Morocco and South Africa. By contrast, corporate income taxes have been stable in most countries because the widespread practice of tax exemptions to corporations. However, corporate income taxes are reported to have been resilient, despite decreases in rates at which profits are taxed across Africa, and increases in the number and type of exemption granted by African countries to investors (AfDB et al. 2010). It is also notable that collections from indirect taxation (mostly VAT, sales taxes and excise duties) declined across Africa in recent years. A few countries use indirect taxation extensively: Burkina Faso, Burundi, Djibouti, Kenya,

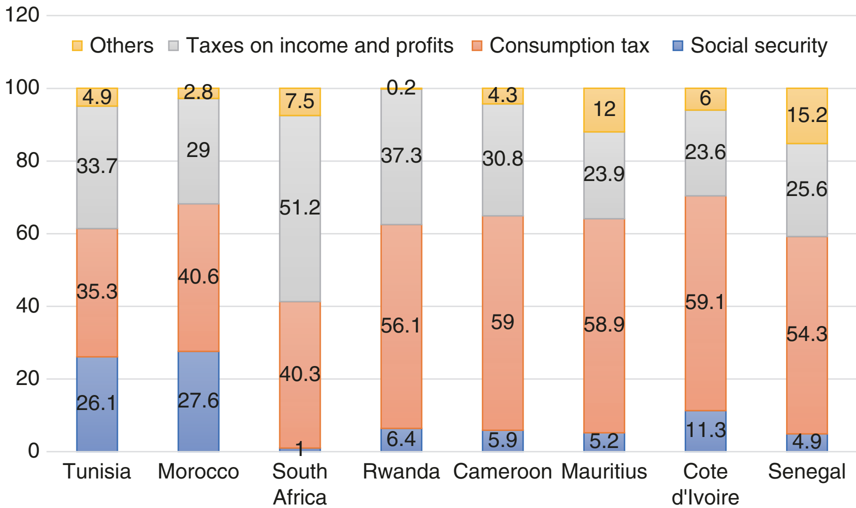

Fig. 4.2 Tax mix for select African countries in 2014 (per cent share of total revenue)

Source: ECA staff computation from OECD's Revenue in Africa database (2014)

Lesotho, Mauritania, Mauritius, Morocco, Mozambique, Rwanda, Senegal, South Africa and Zambia (AfDB, OECD, and UNDP 2013).

Fourth, Africa has seen a marked increase in resource-related taxes in recent years as new finds come onstream. Natural resource-related tax revenues have nearly tripled in Africa as a share of national income between the late 1990s and the start of the financial and commodity price crisis. Because of commodity price decline since 2012, resource-related taxes have declined slightly back to around 15 per cent of GDP on average. However, some countries still have a very high percentage with 66 per cent in Libya and 39 per cent in Angola (AfDB, OECD, and UNDP 2013). Any recovery in crude oil prices will result in a pick-up in resource-related tax revenues as a share of GDP for most oil-exporting countries.

Finally and fifth, a wide range of tax efforts exists across Africa ranging from about 50 per cent up to 250–300 per cent (see Fig. 4.3). Tax effort assesses the performance of a country in tax collection relative to its economic potential. Tax effort is computed by dividing actual tax share

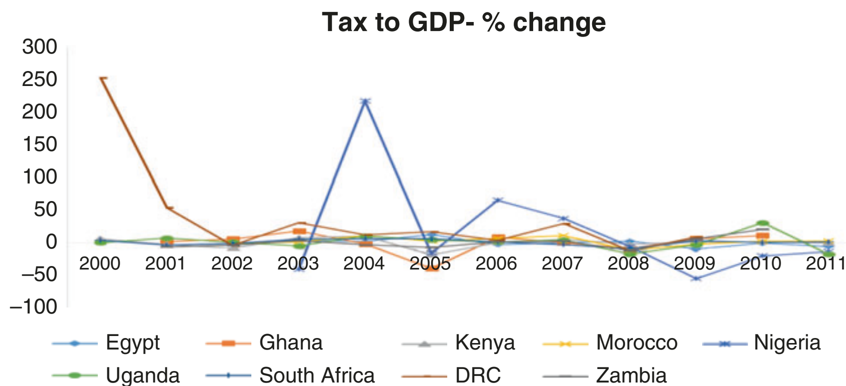

Fig. 4.3 Trends in tax efforts for select countries

Source: ECA staff computation

by an estimate of how much tax the country should be able to collect given the structural characteristics of its economy. It can also be roughly estimated by percentage change in the tax-to-GDP ratio. Some African countries collect as little as half of what they would be expected to, while others collect up to two to three times what they would be expected to. The measure of tax effort is largely unaffected by whether resource-related tax revenues are taken into account or excluded but closely linked to the business cycle.

4.2.2 Taxation and Development

Tax revenue-to-GDP ratios in least developed countries (LDCs) are generally less than 15 per cent except in resource-rich economies (Gemmell and Morrissey 2002). The prevalence of the shadow economy, inefficiency in tax collection, logistical problems and evasion are some of the key reasons behind the low tax-GDP ratio. Some countries have low potential to raise tax revenue from external trade. This can be exacerbated by accession to the WTO, with the implied losses in government revenue following sweeping reductions in tariffs on imports and exports.

Developing countries, including those in Africa, need to increase tax revenue to finance major development initiatives such as the sustainable

development goals (SDGs) targets, infrastructure and climate change adaptation programmes. In the era of declining ODA, governments are intensifying their domestic resource mobilization (DRM) activities via tax collection. Thus, the issue of taxation and development is taking centre stage. The main issues surrounding taxation and development are the design of the tax system and tax reforms; the informality of economic activity; institutions and state building; and the taxation of natural resources (Keen 2012).

African governments require a significant amount of financial resources to allocate to key priority areas such as infrastructure (both provision and maintenance), agriculture and human capital to achieve the SDGs approved under Agenda 2030. This needs to take place within sound macroeconomic framework, careful development planning, debt sustainability and fiscal responsibility. In many African countries, the task of mobilizing more fiscal revenue is complicated by increased mobility of tax bases resulting mainly from trade liberalization, the increasing size of the informal economy and the mobility of investment. Empirical evidence suggests that structural factors, such as per capita GDP, share of agriculture in GDP, inflation, degree of openness and rents received from natural resources, are important determinants of tax revenue. Taking country-specific idiosyncrasies into account, institutional factors such as the degree of corruption and size of the shadow economy also significantly affect tax revenue.

As noted earlier, tax revenue generation has an encouraging evolution over the recent past as some countries have undertaken aggressive tax reforms coupled with improvements in enforcement mechanisms. The tax-to-GDP ratio for African countries (currently at about 20 per cent) is higher than for other developing regions such as Latin America and the Caribbean or East Asia and the Pacific. However, this figure masks the cross-country differences that prevail. In several countries, such as CAR, the Republic of Congo, Ethiopia, Liberia, Nigeria and the Sudan, the tax-to-GDP is below 10 per cent. The low level of the ratio is an outcome of poor collection effort, limited fiscal legitimacy and the regular expansion of the denominator either through GDP expansion and rebasing in countries such as Ghana, Kenya and Nigeria (ECA 2015a). There is a room to improve the ratio given the great potential of the economies where the ratio has been persistently low over the years.

One useful route is to pursue administrative reforms for efficient collection of revenue. This cannot be achieved via a big bang approach

by implicating and arresting or taking other draconian measures on those who fail to pay taxes. The nature of instruments for effective tax collection depends on the type of the taxpayer. Meaning measures that are deployed to pursue multinationals and other big taxpayers are different from measures applied to individuals. Tax revenue can be enhanced via improved service delivery, tax base expansion, tax reforms and efficient administrative measures (Egwaikhide and Udoh 2012). The difficulty of expanding the tax base to activities not adequately taxed is mainly due to policy or administrative weaknesses. The potential of direct taxation has not been explored fully in the formal sector and its potential to contribute to total tax revenue is hampered by the high share of agriculture and the informal sector in the economies of many African countries. Value-added tax (VAT) has been introduced by many countries and their base needs to be broadened to limit their regressive nature. Some of the key tax administration reforms include significant institutional changes for better revenue collection, establishment of anti-corruption units in revenue authorities, tax tribunals and a specialized tax audit unit to handle "mega-projects", financial institutions and extractive industries (Ter-Minassian et al. 2008). One area of potential tax revenue is property taxation which evades the continent for far too long and this is potentially due to the lack of willingness by the vested interest of the property-rich political and economic elite who stand to lose if such tax comes into force. Therefore, there are complex political economy dynamics (e.g. elite resistance to taxation) when it comes to property taxation.

As Fig. 4.4 shows the trend in tax-to-GDP ratio is an increasing one since 2010 particularly for oil importers. Further expansion of this ratio for the oil importers is more likely to continue into the future with the current climate of sliding oil prices which started in the middle of 2014. By contrast, oil exporters have not been in boosting their tax-to-GDP ratio for many decades and it will only get worse in the short to medium term given the gloomy picture of oil prices in the international market. Mineral-rich Africa failed to capitalize on making progression in tax collection despite the potential and this will come at the cost of missed opportunities of investment potential to improve social and economic situations in these countries for citizens. The sobering reality of this foregone tax potential is evident by the fact that the trend in the ratio for mineral rich is similar to those African countries classified as resource poor.

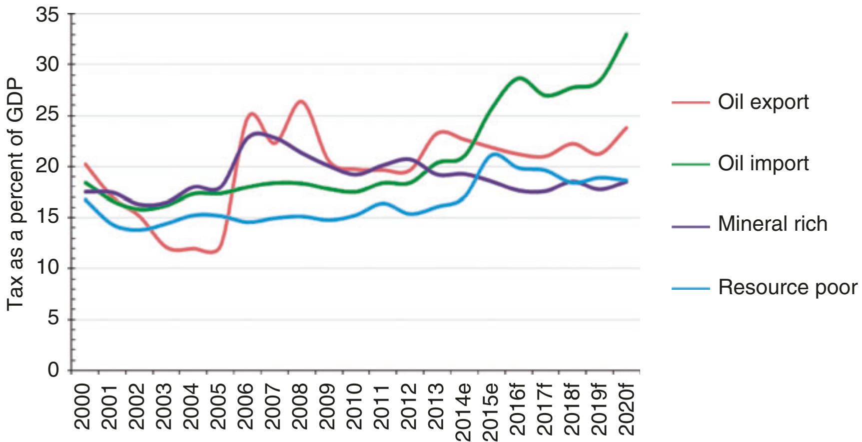

Fig. 4.4 Taxes by natural resource grouping
Source: WDI, World Bank (2015)

Given the increasing importance and call for social protection in Africa on the grounds of inclusive and equitable development, tax policies can be made to focus more on non-labour tax revenue sources (e.g. property and corporate taxation) and more importantly curbing tax avoidance and tax evasion practise of multinationals (Kedir 2014). It is necessary to raise tax revenues but not sufficient to make inroads with regard to the health of the fiscal system in an economy. Equally, it is crucial to have a framework in place that ensures efficiency of the tax system. Efficiency is a budget neutral fiscal reform where a significant improvement can be made given the relative weak institutional structures in many countries. The efficiency of a given tax system can be improved by targeting both domestic and external economic agents (individuals as well as firms). For instance, improving tax administration locally and reducing tax holidays increase the revenue to be recouped from domestic and external economic agents, respectively. The latter should be handled with care as a dramatic curtailment of tax holidays might lead to undesirable declines in investment from potential foreign investors which most likely move to locations with better tax incentives. Countries compete to attract foreign investment mainly by making their tax holiday provisions appealing. Therefore, each government needs to take a conscious decision on tax

holiday provision or other arrangements of tax breaks carefully to avoid a potential race to the bottom. If all countries aim for a reasonable level of tax holiday provisions in some coordinating manner with some inevitable variations, it will ensure that the continent is no longer characterised as a weak tax holiday spot. As inter-country coordination is complex, regional economic forums or supranational organisations in Africa can play a pivotal role to bring countries under one umbrella to protect the continent from exploitation via tax holidays. Regional or multi-country agreements for avoiding unfair tax competitions might be infeasible to achieve in the short term but a long-term solution should be sought by each country to solve the problem of foregone revenue collection due to generous and unreasonable tax holidays.

4.2.3 Tax Base, Design and Reform

Countries have heterogeneous sources of tax revenue, including personal income tax, consumption tax, property taxes, corporate taxation, customs duties and VAT. As noted earlier, some African countries expanded their tax base and increased revenue collection (Auriol and Warlters 2005). For instance, in Ethiopia, tax collection improved significantly after the 2010 tax reform. One of the weaknesses of the tax systems in developing countries is the high burden of taxation on the poorest section of the population (Chu et al. 2000). While most of the poor work in the informal sector and thereby escape direct taxation, most taxes in developing countries are indirect and affect goods that are consumed by the poor. Hence, the poor incur a relatively heavier tax burden than the wealthier segments of the population.

International trade taxes are considered distortionary. Empirical studies show that export taxes are regressive, and there is also strong political, social and economic opposition to eliminate import duties (Chen et al. 2001). Trade taxes are important sources of revenue and often may be a major reason to oppose trade liberalization. However, countries may offset these revenue losses by raising more domestic tax (Emran and Stiglitz 2005). For example, recently Ethiopia introduced a VAT and broadened the tax base after the 2010 tax reform. At the same time, the country is in the final stages of negotiations to join the WTO. Such a reform is often criticized for its detrimental impact on welfare in an environment where the informal sector is important. Emran and Stiglitz (2005) also argue that the entire informal sector escapes the

VAT net and its introduction leads to distortions between the formal and informal sectors as well as between the tradable and non-tradable sectors. The need to tax some items traded in the informal sector in Cameroon is forcefully argued by Benjamin and Claude (2006).

4.2.4 Informality and Smuggling

A substantial share of economic activity in African countries is due to informal activities, and this provides a fertile ground for cross-border smuggling. Smuggling is exacerbated by the complexity of tax systems in African countries. It is distortionary and leads to welfare loss (Stopler and Deardorff 1990).

Formalizing the shadow economy can boost resource mobilization through taxation. The potential tax revenue loss due to informality stands at USD 62.6 billion for the region, where the informal economy accounts for 41 per cent of official GDP. The estimated benefit from taxing informal activities is at 28.7 per cent of official GDP for sub-Saharan Africa (Cobham 2005). Table 4.1 gives estimates of potential tax revenue loss and the size of the shadow economy in selected African countries. The revenue losses are especially high in countries such as Angola, Botswana, Cameroon, Côte d'Ivoire, Ghana, Kenya, Senegal and Zambia.

4.2.5 Institutions and State Building

History and institutions arguably play a role in the type of taxes designed and executed by countries (Acemoglu et al. 2001). For instance, countries' tax systems may differ depending on whether they have a Francophone or Anglophone colonial heritage. Francophone countries tend to make use of VAT withholding and advanced collection schemes and typically follow a territorial approach to the taxation of foreign income. These features are borrowed from tax practices in France (Keen 2012).

Two strands of recent literature highlight the historical role of revenue mobilization in state development. One segment of the literature focuses on the capacity of the state to collect tax revenue, which is shaped by factors such as political stability, the extent of common interests and the degree of political consensus (Acemoglu 2005; Besley and Persson 2010). The second strand of the literature is

Table 4.1 The size of the shadow economy and foregone tax revenue due to informality in selected sub-Saharan African countries, 2011

Country	*Size of shadow economy (per cent)*	*Tax Revenue lost (in millions of USD)*
Angola	46.6	2,399
Benin	49.8	568
Botswana	33	1,481
Burkina Faso	40.5	432
Burundi	39.5	115
Cameroon	32	1,326
Chad	43.7	176
Cote d'Ivoire	45.2	1,565
DRC	47.3	815
Ethiopia	38.7	1,139
Ghana	40.6	2,618
Guinea	39	259
Kenya	33.2	2,179
Lesotho	30.5	410
Liberia	44.2	117
Malawi	41.8	352
Mali	40.7	565
Namibia	30.3	915
Senegal	43.8	1,038
Sierra Leone	45.6	94
Uganda	42.3	856
Zambia	47.1	1,335

Source: Adapted from Tax Justice Network study on "The cost of tax abuse; a briefing paper on the cost of tax evasion worldwide." November 2011

emphasized in policy circles and can be referred to as the "new fiscal sociology." This literature argues that taxation is critical to building state institutions that are responsive, accountable and competent. The key message is that taxation encourages state building by providing a focal point for bargaining between the state and citizenry and by fostering the development of high quality institutions for tax collection (Bräutigam et al. 2008). From an empirical point of view, there is support for devising some sort of contractual agreement between governments and citizens due to its subsequent impact on tax compliance. Others have argued in favour of "implicit" contractual agreements, also based on experimental evidence (Feld and Tyran 2002).

4.2.6 Natural Resources and Taxation

A number of African countries are resource-rich and more countries are discovering natural wealth (e.g. gas and oil in Ghana, Tanzania and Uganda). These countries will be heavily reliant on resource revenues, and this will require appropriate reforms in tax design and revenue management (see ACBF 2013). Tax revenue mobilization can be enhanced under effective institutional arrangements, which are lacking in much of resource-rich African countries (Daniel et al. 2010). Resource exploration corporations evade taxation and resource-rich governments are prone to rent seeking and capital flight. Nevertheless, with accountable and transparent institutions, the potential for raising revenue is enormous. According to the 2010 African Economic Outlook, there is a positive trend in tax revenue in the continent, as illustrated by an increase in the tax-GDP ratio since the 1990s; most of the increase is driven by resource-related tax revenues. Between the early 1980s and 2005, resource-rich countries in sub-Saharan Africa increased their tax-GDP ratios by about 7 percentage points (Keen and Mansour 2010b).

An extensive treatment of resource taxation is given by Daniel et al. (2010) and Collier (2010). The challenge in relation to risk-sharing by low income, resource-rich nations and private producers in the resource sector is discussed by Stroebel and Van Benthem (2013). These studies find that most resource-rich economies of Africa have missed the opportunities of producing lasting value for their societies due to corruption and the squandering of wealth. Hence, they argue for prioritizing the allocation of resources to investment and growth within the continent.

The loss of revenue from natural resources and other activities in Africa is facilitated by tax avoidance and tax evasion practices of multinational companies. There is increasing pressure on large corporations to eliminate their tax avoidance activities across the globe. Some non-governmental organizations such as Action Aid revealed how the multinational corporation SAB Miller paid less tax than the owner of a small kiosk selling SAB Miller beer in Accra, Ghana (Action Aid 2010). Many other MNCs operating in Africa also engage in tax avoidance and tax evasion schemes, including Associated British Foods (ABF), Vodafone, Starbucks, Barclays, Primark, Boots and Silver Spoon & Ryvita. It is estimated that Zambia lost up to US$27 million in revenue due to tax evasion by ABF alone.

4.2.7 Professionally Managing Commodity Funds

Making intergenerational savings and investments is another critical area for consideration in domestic resource mobilisation (Humphreys and Sanndhu 2007; Humphreys et al. 2007; see also Davis et al. 2001a, 2001b). The windfalls of a commodity boom must be used to establish transparent sovereign wealth funds, in order to ensure that future generations share the proceeds, while investing in assets that earn a higher rate of return to smoothen intergenerational income streams (Holmøy 2010; Røed Larsen 2004; see also Truman 2010). Botswana's "Pula Fund", built on earnings from the sale of diamonds, is one of the best continental practices worth emulating (Iimi 2006; Sarraf and Jiwanji 2001; Acemoglu et al. 2003). The fund is made up of securities denominated in other currencies thus acting a sinking fund to offset the depletion of diamonds and a buffer to smooth global fluctuations. The daily management of the Pula Fund is under the care of independent asset management professionals without much political interference. Nigeria also established an oil stabilization fund, the Excess Crude Account (ECA), in 2004. The account, which was very successful during 2004–2008, has faced serious challenges with the recent fall in oil prices.

4.2.8 Combatting Illicit Financial Flows

A major source of pressure on the fiscal space of African economies has been the acts of illicit financial flows (IFFs). Cross-border illicit financial flows often go hand in hand with corruption, and represents an essential ingredient of its international character. Whereas such statement holds true in general, it is particularly pertinent when discussing corruption in Africa because of the magnitude and character of illicit financial flows on the continent. There is a shared perception that illicit financial flows in Africa are of a significant magnitude and that they have increased during the past decade (see Fig. 4.5). The extractive sector is a case in point (Table 4.2).

4.3 Expenditure for Equity and Long-Term Development

The decline in growth and productivity in African countries during the period of the structural adjustment programmes (SAPs) is well recorded. The decline in economic performance and the contribution of the

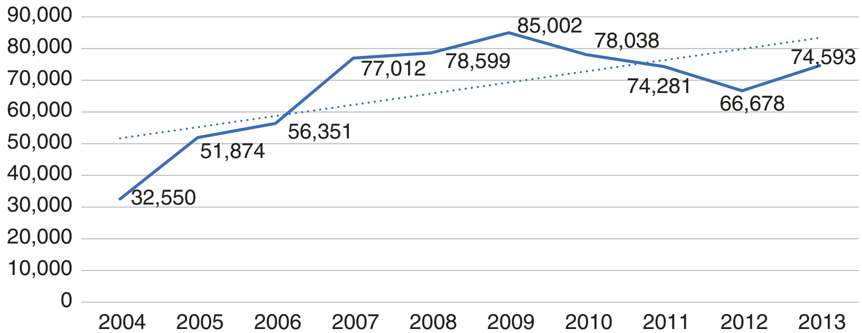

Fig. 4.5 Sub-Saharan Africa (Trends in IFF in US$000)

Source:Computed from GFI Inde x by ECA staff

industrial sector in particular (deindustrialization) can be traced to the minimal productive investment during this time by both the private and public sectors. Partly as a consequence, African countries are now facing significant gaps in productive assets. It is estimated, for example, that Africa's infrastructural needs require US$93 billion annually, with a funding gap of around US$31 billion (Foster and Briceño-Garmedia, 2010, as cited in AfDB et al. 2015). In addition to the hard infrastructure, reduced government spending on "soft" public goods, such as education and healthcare, further reduced productivity growth. It is now recognized that the developmental state can be a strategy for structural transformation. Targeted government spending in East Asian countries contributed to their successful industrialization and a shared growth experience.

Public investment in public goods provides the conditions for the private sector to be able to feasibly invest. Additionally, the work commissioned by the government provides employment directly, stimulating the economy through consumption. Historically, the economy-wide benefits of such investments outweigh the costs. Many African governments have already embarked on large-scale public projects in the last years. Countries such as Ethiopia and Kenya have achieved some of the highest growth rates in the world driven by public investment in transport and energy infrastructure in particular. However, African countries need to rethink their expenditure and financial planning frameworks.

Table 4.2 Corruption-related illicit financial flows in the extractives sector in Africa

Mineral value chain stages	*Corruption*
Licensing	• Risk level: high • Key method: bribery; kickbacks; commissions; nepotism • Loopholes: lack of information on contracts; unfair bidding and award processes
Exploration	• Risk level: low • Key method: unlawful gifts and commissions • Loopholes: unfair bidding and award processes
Development	• Risk level: high • Key method: bribery; kickbacks; commissions; fraud • Loopholes: lack of enforcement of mineral sector regulations (e.g. procurement irregularities; contractual changes)
Production	• Risk level: high • Key method: bribery; kickbacks; commissions; fraud • Loopholes: procurement irregularities; non-compliance and [or] weak enforcement of production regulations
Transport, storage and marketing	• Risk level: high • Key method: bribery; kickbacks; commissions; fraud; • Loopholes: lack of enforcement of mineral sector regulations (e.g. procurement irregularities; contractual changes)
Processing and marketing	• Risk level: high • Key method: bribery; kickbacks; fraud • Loopholes: price manipulation; irregular award of import licenses

Source: Adapted from Extractive sectors and illicit financial flows: what role for revenue governance initiatives (Le Billon, 2011)

4.3.1 *Public Investment, Growth and Poverty*

In the literature, the relationship between public investment and private investment is well established. Private investment responds positively to the rate of public investment, and while in the short run public investment may crowd out private investment, in the long run they are complimentary (e.g. Greene and Villaneuva 1991). However, the evidence on the impact of public investment on growth and poverty reduction is not conclusive, pointing to a need for a strategic view in public expenditure.

Anderson et al. (2006) show that public investment has a positive impact on economic growth. In particular, their evidence supports prioritising

investment in infrastructure (particularly rural) and non-recurrent spending on education. However, the relationship does not maintain robustness across studies and in cross-country analysis, possibly due to differences in the effectiveness of implementation across countries. The impact of investment on growth should also be separated from the question of inclusiveness. There is evidence that investment in rural transport infrastructure and education, and agricultural infrastructure such as irrigation, has a negative and significant impact on rural poverty and inequality (Anderson et al. 2006; Fan et al. 2005). Evidence from Asia points to the fact that while infrastructure is important for increasing rural productivity and creating opportunities, it needs to be accompanied by supporting measures to ensure that all sectors of the population can benefit. This can be, for example, due to high connection costs (to energy infrastructure), unclear land use rights or limited opportunities for agricultural improvement, for example through lack of access to credit (Ali and Pernia 2003).

In order for the growth experience to be inclusive, there is a case for the government to provide services targeting the lowest socio-economic segments of the population and ensuring better infrastructure and human capital.[1] Indeed, such basic services also contribute towards the creation of a social contract between the state and the people and reduction of informality in the economy.

4.3.2 Infrastructure Still Lacking but Improving

The need for infrastructure development in Africa has been embraced by national governments and donors alike. The overall financing for infrastructure in sub-Saharan Africa was estimated to have tripled between 2004 and 2012 (Gutman et al. 2015). A majority of this expenditure is financed by the national governments. At the same time, poor infrastructure remains a challenge for the competitiveness of African economies, increasing cost of trade and resulting in the poor distribution of benefits from the fast development of capital regions. Around 40 per cent of the African countries included in the Logistics Performance Index experienced no improvement in score between 2010 and 2014 (AfDB, OECD, and UNDP 2015). Lack of power is cited by more than half of firms in more than half of African countries as a major business obstacle (World Bank 2016). Simulations by Fosu et al. (2012) find that the optimal public investment rate that maximizes consumption is between 8.4 per cent and

11 per cent, while the average public investment rate in Africa in 2000–2012 was about 7.5 per cent (UNCTAD 2014).

Significant commitments have been made to improve infrastructure. For example in Ethiopia, the Renaissance Dam under construction is estimated by the Ethiopian government to generate 6,000 MW of hydro power and around 15,700 GWh average energy into the national grid, in addition to creating 15,000 jobs.[2] In Zambia, the funds from the issuance of a US$750 million Eurobond were heavily earmarked for infrastructure, with 34 per cent allocated to energy infrastructure and around 57 per cent to the development of the road and rail transport infrastructure (AfDB 2013).

4.3.3 Low Quality Education Holding Back Structural Transformation

In terms of investment in productive capacity, Africa is facing a shortage in human capital. As detailed in ECA (2015b), among others, structural transformation requires not only an increase in school enrolment but also investment in secondary and tertiary education and an improvement in the quality of delivery. A survey of a group of African countries in 2013 showed that one-third of students fall short of the minimum learning threshold for numeracy and literacy. Educational spending is not kept with the increases in population and enrolment rate, further jeopardizing teaching quality (ECA 2015b). Additionally, the skills provided by the educational system do not correspond to the needs of the private sector, resulting in high levels of youth unemployment and lower returns to educational investment. This misalignment may also contribute to the evidence presented in Chapter 3, with educational policy contributing insignificantly to the share of manufacturing and services in value added. One area for a rethink is education financing.

Some successful examples exist of using investment in education as a driver for structural transformation. Cabo Verde is one of the few African countries to graduate from the LDC status. A key contributor was its strategy to invest in human capital development and the educational system. High enrolment and completion rates for primary education and high access to secondary education created the necessary foundation for the move towards higher productivity services, including tourism. Similarly, investment in TVETs and enhancing innovation in tertiary education contributed to the capacity of Mauritius to achieve structural transformation through high-productivity services.

4.3.4 *Addressing Rural Poverty Through Social Protection Programmes*

Structural transformation in Africa should be a quality one, with inclusiveness at its core where redistributive fiscal policy remains critical. In the lack of comprehensive social welfare systems, the existing social interventions in Africa take the form of targeted social protection programmes, often in the form of unconditional cash transfers. Cash transfers have been used to address in particular food insecurity, in contrast with conditional cash transfers more common in Latin America, asset transfers used in South Asia and social insurance mechanisms, for example. A key challenge has been the donor-driven nature of the programmes, which have prevented the scaling up of interventions and mainstreaming of programmes into government development frameworks (Devereux and White 2010).

Positive examples exist however. In Malawi, an input subsidy programme on fertilizer and maize seeds was introduced in 2005. Initially fully funded by the government, the scheme significantly increased Malawi's maize harvest and supported food security in the poor smallholder households. The participating household also reported higher rates of primary school enrolment and improved health outcomes (Chirwa et al. 2013). In addition to the benefit to the direct beneficiaries, it was reported that maize prices decreased (contributing to lower inflation) and increases in agricultural wages. In fact, the authors find that the indirect effects are stronger than the positive impacts directly attributable to the programme.

In Ethiopia, the Productive Safety Net Programme (PSNP) covers around eight million people. While completely externally funded, the programme has been to a large extent nationalized by the Ethiopian government. This has included, for example, the in-built condition of the able-bodied recipients contributing towards community projects such as rehabilitating land and water resources and developing community infrastructure. The programme has been found to improve food security of recipients, increase asset creation and increased utilization of education and health services. A further sign of the transformative impacts of the programme has been the graduation of nearly 500,000 households from the programme between 2008 and 2012.[3]

The focus of African social protection schemes on agriculture and food security is a reflection of the large rural population and continuing dependence on subsistence farming. Targeting the rural population may support structural transformation through improved agricultural

productivity and reduced rural–urban inequalities. It is estimated that lost productivity in manual labour due to child undernutrition in Uganda, Ethiopia, Egypt and Swaziland ranged between US$15 million and US$2.0 billion (AUC et al. 2014). Improving food security in the rural areas may therefore have considerable benefits for agricultural productivity. Additionally, historical experiences suggest that sustainable industrialization needs to be based on improved productivity in the agricultural sector (see ECA 2016a).

Furthermore, internal rural–urban migration in Africa has largely been "out of misery" – escaping low living standards and poor services – rather than reflecting the move of labour towards more productive opportunities. Increased urban population puts pressure on the delivery of public goods in cities and contributes to the creation of urban slums. Improving living standards in rural areas can therefore help buffer some of these effects.

Given the importance of poverty and regional inequality, it is critical that individual African countries decide on strategic choices and investments and related resources required to make growth and economic transformation sustainable and inclusive.

4.4 Prudent Fiscal Management for Long-Term Growth and Structural Transformation

While the revenue side of fiscal policy is important, the expenditure side is equally important and must be at the core of how Africa delivers its structural transformation agenda. The continent needs to develop processes of making decisions around public finances in ways that maximizes the marginal social benefits while lowering the costs of fiscal policies. This process is principally undertaken during budgeting. A centrally coordinated budgeting process may help reduce the common pool problem through coordinating the spending decisions of individual politicians, by forcing them to take a comprehensive view of the budget. Competing claims must be resolved within the budgeting process, but this limit may be undermined by use of off-budget funds, spreading of non-decisions (such as indexation), mandatory spending laws and contingent liabilities (e.g. promised bailouts). It is also important that countries have sufficient and sustainable fiscal spaces. Prudent fiscal management demands strengthening various aspects of economic governance – especially public financial management to ensure results for every spending commitment.

Better service delivery is most likely than not to foster tax compliance thus boosting domestic resource mobilization.

4.4.1 Fiscal Sustainability

A fiscal position is sustainable if the present value of future or long-term primary surpluses equals the current level of debt (the so-called intertemporal budget constraint). If this condition is met, the government avoids excessive debt accumulation, is able to roll over its debt and there is no risk of insolvency. Fiscal sustainability should be a long-term growth concern that needs to be addressed in light of, for examples, the infrastructure investment requirements, increasing health spending and other welfare spending for an aging population. Fiscal reform packages that fail to appreciate the expansion of fiscal space[4] for revenue collection (e.g. through taxes from the working population) in the future will jeopardise fiscal sustainability. Therefore, African economies are required to have a long-term and strategic view about their fiscal situation. There are various ways of increasing Africa's fiscal space. Some measures include a shift in or creation of new revenue composition, and improving existing revenue composition. It is not clear whether broad-based introduction of taxes such as VAT or taxes that are product targeting is the way forward.

The recent fiscal revenue of African governments is summarised in Fig. 4.6. According to the various economic groupings, oil exporters have the highest revenue-to-GDP ratio followed by mineral-rich and oil importers. Unsurprisingly, resource-poor African countries are characterised by the smallest ratio of revenue-to-GDP. However, the overall picture is encouraging as the ratio displays an upward trend increasing over time with optimistic forecasts until 2020 assuming current trends continue to prevail.

There are some key considerations with regard to fiscal and debt sustainability in the face of rising growth and public investment expenditures. First, governments need to assess the sustainability of their country's current debt burden and analyze the consequences of any expansion of sovereign borrowing (i.e. from non-concessional loan sources at market rates) for future fiscal sustainability. The concern over the potential debt distress emanating from debts accumulated via sovereign bond issuance was highlighted in the 2015 African heads of states summit. Sustainability concerns should be taken in the context of comprehensive medium-term debt management strategy. Second, governments need to consider any

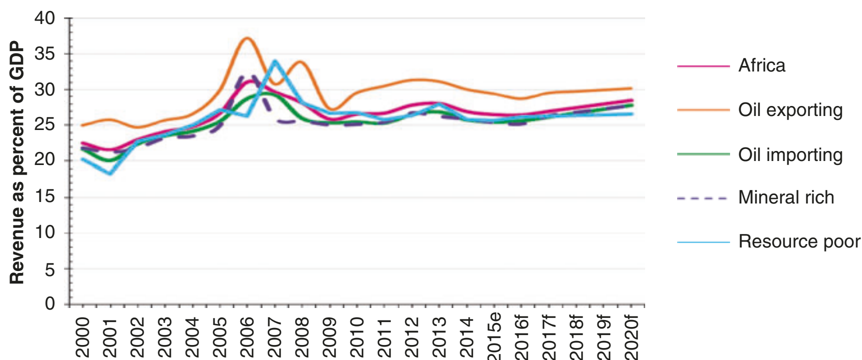

Fig. 4.6 Revenue by economic grouping

Source: Compiled by ECA from IMF (2015)

expansion in borrowing within the context of a comprehensive medium-term strategy for sovereign debt management. Third, governments need to explore the scope for utilizing domestic credit markets as a source of long-term financing. Finally, governments contemplating accessing international capital markets need to consider the fundamental objectives of any sovereign bond issuance. The absorptive capacity of both the domestic macroeconomy and the infrastructure sector itself are critical considerations. Finally, governments need to have the capacity to manage the exchange rate risk associated with substantial holdings of foreign currency denominated liabilities.

A caveat needs to be added to the discussions in this subsection. First, fiscal sustainability is related to the growth rate and the interest rate. A less than satisfactory rate of growth, coupled with rising costs of borrowing, may result in unsustainable debt burden. The government budget constraint provides the linkage between taxes, expenditure and alternative sources of financing of public imbalances. The central bank is critical in circumscribing the deficit by support government in the issuance of domestic bonds, foreign borrowing or borrowing from the central bank itself. The activities of the central bank in public debt management create the link between fiscal and monetary policies. Second, infrastructure and health spending themselves aid the growth rate. Finally, fiscal sustainability may itself not be the key issue: since by reference to the sectoral imbalance

equation outlined in Section 4.1, the private sectoral balance and/or the current account deficit may be in themselves unsustainable. But also by reference to that equation, the budget position may well be a surplus rather than deficit. In many industrialised countries, savings tend to exceed investment, leading to some combination of budget deficit and current account surplus. But for non-industrialised African countries, investment requirements are known to be greater than savings which may point to some tendency towards budget surpluses.

4.4.2 Austerity Versus Fiscal Expansion

Fiscal austerity or "contraction" refers to circumstances, whereby government cut spending/raise taxes with a number of objectives such as avoiding economic overheating, reducing the debt-to-GDP ratio, strengthening long-run debt sustainability or combination of these. By contrast, fiscal stimulus or "expansion" refers to government raising spending/cutting taxes to provide short-term economic stimulus to foster growth and employment. These various actions are based on the notion of fiscal multipliers. The multipliers generate spillover effects of government fiscal decisions (O'Farrell 2013). For example, an infrastructure project has spillover effects as building workers spend their incomes, giving a further boost to the economy via revitalization of aggregate demand. If government decisions to invest in the said infrastructure had no spillover effects, then the multiplier would simply be one. A fiscal measure has a positive effect if the multiplier is above 1. However, in an overheating economy, the multiplier is likely to be less than 1. Such as economy has limited capacity to absorb any extra spending, and private sector activity is "crowded out". The rule of thumb in macroeconomics is that raising public spending has a positive multiplier (in all but the most extreme circumstances), while increasing taxes has a negative effect. Note that the effects of a particular budget position and of any changes in such position cannot be set out without consideration of savings, investments and current account behaviour. Historically, the "Keynesian" view was that governments could boost aggregate demand in the economy and reduce the negative impact of the business cycle. Essentially, government spending stimulated the economy, and taxes dampened the economy. However, in the 1970s, the hypothesis of "Ricardian equivalence" rejected the efficacy of fiscal policy and the necessary policy distinction

between austerity and fiscal expansion (Barro 1974). The idea was that if government attempted to stimulate the economy (and in the event raising the public debt), households would anticipate future tax increases necessary to pay for the stimulus by speeding up savings resulting into fiscal neutrality. However, this hypothesis requires that households act as though they give infinite lifespan and with perfect access to credit (DeLong 2012). An extreme version of the hypothesis of "expansionary fiscal contraction" (Giavazzi and Pagano 1990) posits that in a recession, government cutbacks may actually cause the economy to expand. Households and the wider economy are presented to have confidence in the government getting to grips with a crisis, thus inspiring the private sector to spend and to invest (DeLong 2012). The experiences of Ireland and Denmark in the 1980s are usually presented as examples (see Bradley and Whelan 1997 for counter positions). Of note is the reality that various theoretical and ideological approaches exist on the question whether a country can choose austerity versus expansion. Indeed, fiscal consolidation or austerity may have dramatic consequences for combating economic downturns as well as investments for long-term structural change (Kararach 2014).

What is the best fiscal policy for structural transformation, austerity or expansion? While the behaviour of the elements of the sectoral balance equation of Section 4.1 provides a partial answer, the question requires more than a technocratic answer and includes political economy considerations. Indeed, any such answer depends where the economy is in the road of long-term change. Historically, post-independent African countries had political systems that produced procyclical fiscal policies as booms were used to expand investments import-substitution industrialisation. Almost all of them showed a positive correlation between government spending and the business cycle during 1960–1999. But such approaches to fiscal have changed. For example, Botswana took advantage of the diamond boom years 2003–2007 to strengthen its budget positions, saving up for a rainy day using the Pula Fund. Arguably, all African governments should follow this approach of countercyclical spending and adopt strategic approaches to the management of debt financing as well as inter-generational saving schemes (Kararach and Odhiambo 2017). Indeed, the general trend has been that African countries increased their public debt positions from the 1980s to the 1990s before these fell in the early 2000s; and since 2009, fiscal expansion seems to have resumed (see Fig. 4.7).

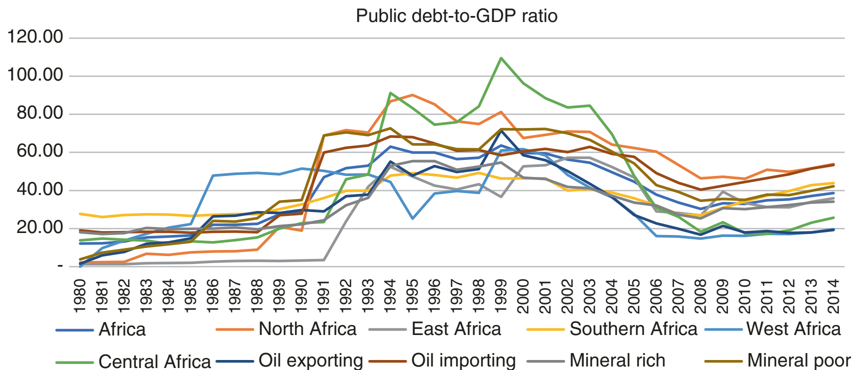

Fig. 4.7 Trends in public debt-to-GDP ratio

4.4.3 Tax Compliance and Service Delivery

As discussed earlier, most existing efforts in fiscal policy focus mainly on improving tax administration with little focus on improving tax compliance/morale which significantly enhances revenue administration. Tax revenue can be wisely invested by governments to provide services which in turn improve the tax compliance of the electorate. This creates a virtuous cycle of increasing tax revenue and the implicit social contact between taxpayer and the government will be beneficial by making the revenue stream and fiscal condition of a given economy predicable.

Issues of taxation and development (e.g. tax reform, tax base, tax administration, tax evasion, informality and taxation) are gaining renewed and increasing interest from both academic and policy circles (Keen 2012). In the current climate of economic crisis, austerity measures and declining foreign aid, governments are trying to raise revenue by fighting tax evasion, improving tax compliance and expanding the tax base (AfDB, OECD and UNDP 2010). Tax evasion is damaging to any economy; thus, it deserves serious consideration in both academic and policy circles. It weakens the cardinal virtues of social justice and efficiency (Cowell 1990). It distorts prices and incomes, and renders macroeconomic policies ineffective (Adam and Ginsburgh 1985). Tax evasion has diverse detrimental consequences on different economies depending on the tax structure. For countries that rely on natural resources (mineral ores and fuel), there is limited diversification and the tax base is dependent on taxing a few companies that often engage in financial engineering to avoid paying

taxes. Thus in a resource-rich, less diversified economy, tax evasion is highly damaging.

Raising revenue through taxes is especially important given the short-term nature of donor assistance, which does not guarantee sustainable development for Africa (AfDB 2010). In the continent, there have been lukewarm attempts to make credible tax reforms, collect data to measure the extent of tax evasion, and study its determinants. Many governments rely heavily on donor assistance and taxing international trade, which are not long-lasting solutions in the current aid architecture. In addition, increasing membership of nations to the WTO has detrimental implications on the revenue of African governments that rely excessively on trade taxes. With widespread smuggling and large informal sectors, developing capacity for combating tax evasion and enhancing tax compliance is not a simple undertaking (Bajada and Schneider 2005). The issue is not restricted to economics; it also involves law, politics, culture and trust between the government and its citizens. The key challenge to understanding the extent of tax evasion in Africa is lack of data and relevant evidence due to the sensitive and complex nature of micro surveys on the issue. There are a few studies on tax evasion based on some country case studies but this needs to be scaled up (Levine and Widell 2007). In this chapter, we briefly provide a framework and identify research issues on tax evasion in Africa.

Economic theory often presents the tax evasion decision as a choice under uncertainty (Hindriks and Myles 2006). In the literature, a game-theoretic characterization of the strategic interaction between taxpayers and governments is also common. There are a number of studies that show the key determinants of tax evasion or tax morale for a variety of countries across the glow mostly based on econometric and experimental evidence (Slemrod 2007). Beyond economic considerations, we will also focus on underlying fundamental issues that potentially reinforce or hinder tax compliance in the continent, such as the political and institutional environment, culture and trust (Torgler 2004a, 2004b; Blackburn et al. 2006; Hindriks et al. 1999; Andreoni et al. 1998).

4.4.4 Tax Compliance and Institutional Variations

One could also argue that the quality of institutions in a given tax jurisdiction would influence the levels of compliance both directly and indirectly. Directly, the capacity of the authorities to enforce compliance is linked to

the quality of the institutions necessary for carrying out "enforcement tasks". These include the tax agencies that undertake tax audits and relevant courts to mute out necessary sanctions or other aspects of tax administration. Indirectly, the quality of institutions will affect the abilities of the state to deliver the critical services circumscribed in the social contract discussed above. Some studies have shown that there is the tendency that ethnic fractionalization negatively influences economic success and the quality of institutions (see e.g. Easterly and Levine 1997; La Porta et al. 1999; Alesina et al. 2003). Easterly and Levine (1997) found for Africa that greater ethnic diversity goes in line with low schooling, underdeveloped financial systems, distorted foreign exchange markets and insufficient infrastructure.

Some authors argue that history, alongside institutions, plays a role in the type of taxes designed by countries (see e.g. Acemoglu et al. 2001). In Africa for instance, countries' tax systems may differ depending on whether they have a Francophone or Anglophone colonial heritage, but they both use VAT, considered as the most important tax reform adopted by more than 140 countries around the globe during the last 50 years (Ebrill et al. 2001). Francophone countries tend to make use of VAT withholding and advanced collection schemes and typically follow a territorial approach to the taxation of foreign income. These features are borrowed from tax practices in France (Keen 2012). Until a recent period, their major challenge came from the traditional division between the fiscal institution (in charge of tax base and audit) and the public accounting institution (collecting taxes).

Following the French model which has a unique "direction générale des impôts", some Francophone African countries have or are adopting a similar model. Benin and Togo did it earlier (in the 1990s) and were followed by others (Mauritania, Morocco, Senegal and Cote d'Ivoire) (Bodin 2012). Historically, in Anglophone countries VAT and other indirect taxes were managed by customs. Sixteen of 19 Anglophone African countries have established since the early 1990s some sort of revenue authority for greater governance and financing. Beyond other limitations and capacity issues, the introduction of VAT in these countries heralded self-assessment, but in most cases was not properly integrated into the income tax administration, but rather assigned to a separate department. Despite some recent improvements (such as the creation of special units for large taxpayers), challenges still remain, explaining the too low tax-to-GDP ratios for mobilizing domestic resources.

Two strands of recent literature highlight the historical role of revenue mobilization in state development. One segment of the literature focuses on the capacity of the state to collect tax revenue, which is shaped by factors such as political stability, the extent of common interests and the degree of political consensus (Acemoglu 2005; Besley and Persson 2010). The second strand of literature is emphasized in policy circles and can be referred to as the "new fiscal sociology." This literature argues that taxation is critical to building state institutions that are responsive, accountable, and competent (Baskaran and Bigsten 2013). The key message is that taxation encourages state building by providing a focal point for bargaining between the state and citizenry and by fostering the development of high quality institutions for tax collection (Bräutigam et al. 2008). From an empirical point of view, there is support for devising some sort of contractual agreement between governments and citizens due to its subsequent impact on tax compliance. Kedir et al. (2014) show that tax morale or compliance is positively and significantly affected when governments provide series. This confirms the social contract or mutual agreement between taxpayers and the government. Hence, one way of guaranteeing tax revenue generation and collection is provision of services to citizens which works much better than pursuing offenders and threatening them with punishment such as serving jail terms and bear huge financial fines. Research also argued in favour of "implicit" contractual agreement based on experimental evidence (Feld and Tyran 2002). The random control trials/experiments by Cummings et al. (2005) in South Africa and Botswana confirm the importance of quality institutions in influencing the tax compliance.

4.4.5 Public Financial Management, Macroeconomic Stability and Economic Governance Institutions

Effective public financial management (PFM) contributes to macroeconomic stability. As one of the core elements of economic governance, PFM functions and systems help the state to undertake some of its core functions including the maintenance of fiscal discipline and efficient and effective allocation of public resources for service delivery.

Public financial management systems contribute to improved macroeconomic stability by supporting effective fiscal management and debt strategies aimed at avoiding unsustainable deficits. Three ways in which this can be achieved are: (1) the provision of timely and reliable information on the fiscal and financial position of government by tracking expenditure; (2) a basic understanding of the over debt position of the government

through data on past and forecast and medium-term debt positions; and (3) the maintaining of awareness on key fiscal risks and for many African countries that rely on primary products, such risks could include fluctuations in global commodity prices and also inconsistency of budget support from external sources of finance (see Fig. 4.8).

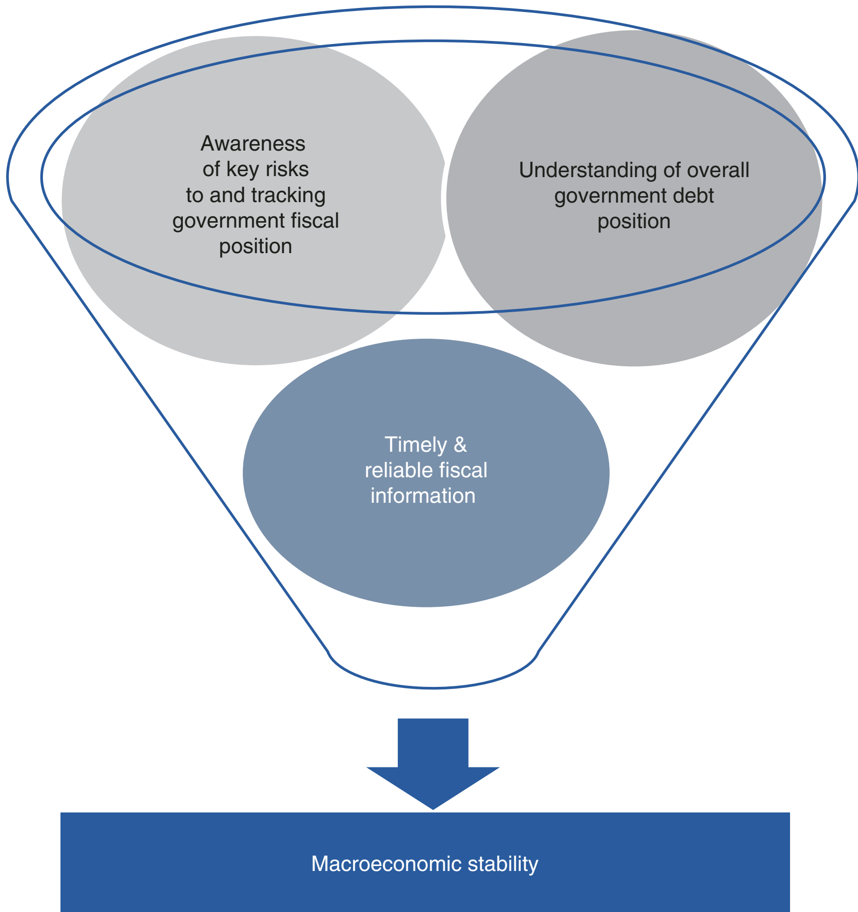

Fig. 4.8 The contribution of PFM functions to macroeconomic stability

Source: Adapted from Welham et al. (2013)

Country characteristics are important for defining PFM systems and there exist specific factors that influence the quality and outcomes of PFM systems (Andrews 2010). Based on data from PEFA[5] PFM performance assessments, Andrews finds that economies that are growing have stronger PFM systems, have the possibility to raise more revenues and endeavour to implement international best practices including improvements in procurement, cash management, auditing and legislative budget reviews; stability delivers PFM progress as some of the lowest PEFA performers are usually fragile states PFM systems are usually comparatively weaker; fiscal states have stronger PFM systems than rentier states; longer periods of commitment to broad reform foster PFM progress as they provide more space for reform; and colonial heritage is key, with Anglophone countries undertaking more PFM reforms and also adhering to more best practices than their Francophone counterparts.

Empirical studies have also found an association between countries experiencing PFM improvement and strong economic growth (Andrews 2010). Indeed, recent data from the Ibrahim Index of African Governance (IIAG) shows that performance on indicators related to aspects of public management has been improving positively over time, even during times, when there was a decline in GDP growth (Fig. 4.9).

Global comparisons and experiences provide Africa with inspiration and information on areas for improvement in PFM. The quality of public administration, budget and financial management systems in sub-Saharan Africa lags behind that of other global regions (World Bank

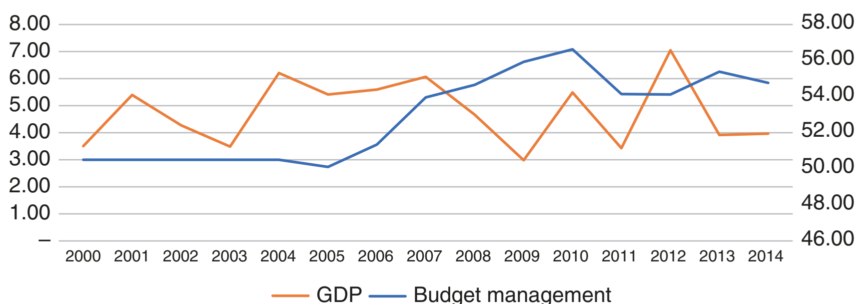

Fig. 4.9 Trend in GDP growth and budget management for the Africa Region

Source: ECA Staff with 2015 data from Ibrahim Index of African Governance

2015). Although when it comes to public sector performance along the dimensions of transparency, accountability and corruption in the public sector, sub-Saharan Africa performs better than the Middle East and North Africa, is equal to Europe and Central Asia (ECA), although lower than in Latin America and the Caribbean (LAC), and of East Asia and the Pacific (EAP). Although below ECA and LAC, for sub-Saharan Africa, the quality of efficiency in revenue mobilization is the strongest governance category and comparable to EAP and South Asia, and the continent has seen improvements in the dimension of accountability.

Countries that are making improvements are committed to implementing reforms in their PFM systems and strategies. Among them, Chad, Ethiopia, Lesotho, Malawi, Uganda and Zimbabwe are known to have improved their public financial management by making targeted improvements in specific PFM components including planning, reporting, audit compliance and budgetary practices, and backed by strong institutional efforts.

Institutions, both formal and informal (Menard and Shirley 2005), written and unwritten rules, norms and constraints are to reduce risk, uncertainty and transaction costs, and they are to help human beings to control their environments. The performance and outcomes of a country's PFM is influenced by the effectiveness of a number of key institutions. Despite variations in nomenclature and functions given the context, institutions engaged in the PFM system and process include the Office of the Prime Minister which initiates and manages policy, Ministries of Finance, Planning and Economic Development; the numerous line ministries that execute the budget; the Public Service Commission; Ministry of Local Government; Revenue Authorities and Customs Agencies; Parliaments; Civil Society Organizations and the media that perform the watchdog role. The incentives embedded in the organizational structures of these institutions and available capacity determine the choices and shape the actions of agents in them.

4.4.5.1 Development Planning, Fiscal Tool Selection and Budget Switching

Another key element of fiscal management as part of PFM is the need to link fiscal policy to development plans. The importance of development and fiscal planning has been in the minds of policymakers for a while. Khalid (1969) is one such pioneer in the discussions. African countries need to adopt expenditure policies that focus on both stability and long-term growth by planning carefully the current and capital expenditure

depending on their impact on development, and protecting these levels of expenditure from fluctuating by using the currently huge accumulated foreign exchange reserves sitting with most of their central banks. There has to be careful long-term planning and coordinated annual budgeting.

To resolve the technical problem of coordinating long-term development programmes with the annual budgets require two things for the development programme and the current budget: (1) the development programme has to have flexible budgetary allocation allowing government to vary its development expenditure among commodities, time periods and localities as changes in prices and incomes require or as bottlenecks occur; and (2) the level and composition of current expenditure must always be subjected to rigorous examination to eliminate waste and to ensure their proper growth in line with the development programme. The second point is important because a successful policy of stabilization for economic growth will first prioritise (re)current expenditure rather than development expenditure.

A major requirement of development and stabilization policies is, therefore, a careful analysis of the composition of government spending and the shifts in this composition from year to year in line with national and regional priorities. This brings into play issues of tool selection, sequencing as well as budget switching. For example, a question may arise whether tax policy is more appropriate than expenditure policies for short-run stabilization. Indeed, any such judgement must take into the reality that the lags between tax assessments and revenue collection in Africa tend to be large. Any inflationary pressures (or the so-called Tanzi-Olivera effects) as the recent example of Zimbabwe shows may worsen the government budget constraint (Kararach and Otieno 2016). It is thus critical tax policy must have an inbuilt long horizon to avoid ignoring the long-run implications for economic and social development. Planning and fiscal authorities must develop the necessary skills to understand the fact that heavy reliance on import duties and the relatively unimportant role of personal income taxes in many African countries suggest that revenue policies alone cannot be the prime tool in successful stabilization and long-term development policies.

Any revenue policy must not contravene the larger strategy of economic development and stability. Revenue management may require some form of built-in stabilizer that is outside the reach of pressure groups. It is important to keep the economic dynamic and prevent smuggling or too

large sales in the domestic market because of excessive import and export duties. Equally critical is the need to strengthen tax administration in African countries. The timely collection and effective management of direct taxes strengthens their anti-cyclical significance and facilitates implementation as well as the monitoring and evaluation of the development programme.

While the identification of economic categories as outlined in the fiscal and financial accounts of government is important, it is however not sufficient in providing a good understanding of the links between government transactions and structural transformation. Although most (re)current expenditure on goods and services does not have a significant impact on the economy's capacity to expand, certain types, such as agricultural extension services and technical training institutes, actually do. Also, we need a caveat mentioned in Section 4.3.1 that not all public investments contribute significantly to a country's ability to produce. Equally, the contribution of the government to national savings is critical to development efforts. Logically, an appropriate design of budgetary processes must take on board for analysis the development impact of government transactions by, for example highlighting current savings and adding two extra concepts to the classification: (1) the development expenditure and (2) the functional classification showing the sectoral distribution of development expenditure in the economy.

Development expenditures encapsulate expenditures that enhance the productive capacity of the country or economy. All growth-inducing expenditures should not be misleadingly considered as simple consumption. Within this framework, fixed capital formation can be retained only as a special type of development expenditure.

The literature on economic growth has tended to overemphasize the role of fixed capital formation in development, resulting into a number of African countries devoting a considerable proportion of their resources to accumulate physical assets at the expense of the so-called current budget. The result was imbalance and lack of funds to utilize additional capacity created by new investments-cum-white elephants. An awareness of this problem in fiscal management is particularly important for a well-coordinated budget policy for structural transformation.

In essence, expenditure and revenue policies for long-term structural transformation as well as economic stability require (1) the building up of sufficient foreign exchange reserves during boom periods to be utilized in recessions to ensure an uninterrupted implementation of the

development programme; (2) long-term expenditure programmes to be as flexible as possible to allow for budget switching; and (3) a careful coordination of annual budgets with the development plan to follow-through with strategic implementation. Item (3) may have to take into account the possibility of fiscal decentralization to reflect the needs consequent of decentralized governance that characterized many African countries.

4.4.5.2 Implementing Effective Public Financial Management: The Case of Ethiopia

Three approaches exist in the design and management of PFM systems and institutions. The "traditional"/"Old Public Administration" model is characterized by top-down approach with high values of hierarchy among public officials, who focus on command and control organizational structures. To make up for the shortcomings that emanate from large bureaucracies, the "New Public Management (NPM)" approaches grounded in private sector managerial techniques applying market-driven competition, business-like service delivery, results-based performance, user fees, client orientation to promote efficiency and value for money. More recently is the adoption of "New Public Service" or the "New Public Governance" or the "post-New Public Management", which places emphasis on public interest through their inclusion in policymaking processes, and the holding of public officials accountable to citizens. Over time, developing countries have embraced the NPM approach with various levels of success, but leading to the conclusion that a hybrid arrangement that integrates desirable aspects from each approach is advisable given country-specific needs and contexts.

In the African context, in addition to strengthening PFM systems and institutions for positive outcomes, there is also need to improve execution and implementation. This execution/implementation is usually influenced by the incentive structure that is available to actors in PFM-associated institutions. Incentive structures may comprise the levels of autonomy available to the actors, the amount of remuneration available to them and their capacity to perform their duties and responsibilities, among others. Public sector reforms that have realigned incentives in PFM have shown positive results. Political incentives have a strong role to play in determining whether the information emanating from the PFM system is utilized effectively by decision-makers, in a manner that has a positive effect on macroeconomic stability.

Table 4.3 Ethiopia's implementation of elements of NPM in its PFM

NPM element	*Specific implementation*
Decentralization	PFM reform was undertaken through the decentralization support activity (DSA) project, which established seven principles that guided the reform: (1) financial reform should be led by finance institutions; (2) devolution should be completed before the budget and accounts reforms are introduced; (3) simplification of the wereda financial management (reducing the number of budget institutions) should precede the budget reform; (4) accounts should be current before the budget reform is introduced; (5) budget reform should precede accounts reform; (6) reforms should be properly resourced; and (7) senior government officials should understand the reform. Regional management institutes were formed and trained in budgets and accounting.
Strategic Planning and Management	The DSA project followed a strategy of four processes and tasks of public sector reform including recognize (sitting systems), improve (existing good practices), change (for improvement) and sustain (the reform to ensure effectiveness of the PFM system).
Customers (one-stop shops, case management)	The "weredas" (districts) were capacitated to deliver frontline services, including primary education, health care among others eventually.
Performance measurement Accountability for performance	Wereda performance agreements were linked to fiscal transfers and based on sectoral cost drivers.
Performance auditing	Accounts changed from there being a backlog of six to seven years for reporting to being current.
Changed management style	Budget submission changed from being compiled a few days before parliamentary review, to a month in advance.
Improved accounting	Changed basis of accounting from cash to modified cash and accrual accounting was adopted. Chart of accounts was changed from multiple series to single series.
Personnel management (incentives)	Relevant staff were trained in budgets and accounts.
Improved financial management	Financial management was devolved to the "weredas" (districts). This is besides introduction of financial management techniques including Medium Term Expenditure Frameworks (MTEF), performance/ programme budgeting Integrated Financial Management

Table 4.3 (continued)

NPM element	*Specific implementation*
	Information Systems (IFMIS) accrual accounting and business process reengineering.
More use of information technology	IFMIS were adopted. Financial information systems were installed using international IT standards, operating on online through low bandwidth and operating in five local languages.
Separation of politics and administration	Government was committed to comprehensive civil service reform (of which PFM was a component) that was based on existing systems, despite political triumph of one ethnic group. Federal government did not monopolize reform.

Source: ECA staff, adapted from Gruening (2001) and Peterson, (2011)

Ethiopia exemplifies how the linkages between institutional strength and political incentives converged to generate positive results, leading the country to become another example of a PFM system of international standards, on the continent of Africa (see Table 4.3). While it is argued that one of the reasons developing countries have adopted NPM techniques and practices is due to pressure from external factors including donors, Ethiopia solely owned, and autonomously undertook reforms starting in 1995. While the country did not fully embrace private sector techniques including privatization and contracting out, it adopted specific elements, techniques and components of the New Public Sector Management (NPM) paradigm and the country further showcases that institutional reforms are possible, irrespective of a country's level of development.

In the case of Ethiopia, there has been increasing discussions on the specific role of ministry of finance in PFM. A pending issue has been on the redefinition of institutional mandates whereby, for example, resource allocation and execution should be given to the planning commission (instead of being the task of the ministry of finance). The argument in favour of this change is that this mandate shift would ensure a better focus of resources on top priorities and a better implementation of the national plan (GTP II growth and transformation plan). However, this debate inside the Government of Ethiopia shows the need to discuss better the implications of institutional disposals for fiscal policy – especially fiscal management – and structural transformation.

Maximizing outcomes from PFM functions and institutions in a manner that generates macroeconomic stability is not enough; there is need to incentivize actors in the various institutions in the PFM system with a long-term view of fostering sustainable transformation and development by enhancing medium-to-long-term expenditure frameworks. As the case study shows, Ethiopia has one of the best-performing PFM systems in Africa. In order for PFM to successfully facilitate structural transformation, there is need for strengthening supportive institutions through relevant approaches to public sector management.

4.5 Conclusions

This chapter started by noting that any discussions on the efficacy of fiscal policy must be anchored on the sectoral balance equation. The equation underlies the traditional approaches to fiscal policy based on the general Keynesian idea that there is no automatic mechanism that can ensure aggregate demand high enough to ensure "full" employment or high levels of and sustained economic activity. Firstly, fiscal policy when prudently executed need not lead to crowding out effects and secondly, generate political business cycles and supply-side inefficiencies. The presumption of crowding out occurs through four broad mechanisms: (1) with fiscal expansion, the rate of interest might rise and private sector investments fall. However, this requires that the supply of money is exogenous and the interest rate is an equilibrating tool. The idea that crowding out does not depend on the behaviour of the monetary authorities does not seem to be reflected in the real world of powerful central bank officials. Indeed, accounts have to be taken of the sales turnover and cash flow effects on investments in relation to the interest rate elasticity of investments; (2) a fiscal expansion would affect savings negatively if the deficit rises and swallows up savings, thus reducing investments. The current account also has to be affected by the rise in deficit, resulting in the appreciation of the exchange rate and a rise in capital inflows; (3) any fiscal expansion should generate supply-side adjustments with a view to matching aggregate demand to generate general equilibrium in the economy. Given an exogenous money supply, this adjustment is derived from the real balance effect whereby price level-related changes generate a decline in the real value of a given stock of money and thus the level of aggregate demand. This ignores the possibility of aggregate demand

influencing the supply in ways that do not necessarily generate inflation but increases in output and employment opportunities; and (4) the Ricardian equivalence mechanism has to hold: government debts are equated with taxes and consumers know the government budget constraint and realise that higher taxes today will be followed by lower taxes in the future. Households reduce their current savings in the knowledge that future debt burdens will be limited. As such, increases in taxes are associated with a fall in savings, and the levels of permanent income and long-term consumption remain unaffected by tax variations. In all these scenarios, fiscal policy is not a potent tool for long-term transformation.

The effectiveness of fiscal policy is anchored on its functional character. The budget should be utilised to sustain a high level of economic activity under conditions where it would have otherwise been lower. Fiscal policy should be guided by some specified socio-economic objectives – such as reduction of poverty, provision of health and education, and social protection. From a "functional" perspective, fiscal policy is critical for regulating the relationship between savings and investments through the use of the budget deficit[6] as evidence the sectoral balance equation. The issue here is the tendency for a gap to exist between savings and investments and the consequent unbalanced budget to fund the shortfall. Any worry about the budget deficit or even debt sustainability especially the need to repay interest can be misplaced, as such repayments need not come from current tax revenues. Interest payments can be made from further borrowing and in any case, government spending should be undertaken in relation to some socially responsive objectives such as the sustenance of employment and Africa's broader structural transformation agenda.

Alongside the above issues, African countries need to pay attention to fiscal management. As noted in Chapter 3, traditional macroeconomic programmes tend to focus by specifying targets for inflation, output growth, domestic and foreign borrowing, and the overall balance of payments to achieve economic stability. But as noted in Chapter 2 and this chapter, Africa needs to moves beyond issues of stabilization. It is important to adopt fiscal management frameworks that ensure efficient resource use and combatting leakages associated with economic governance failure including corruption and illicit financial flows. A number of institutional reforms need to be taken to strengthen fiscal management including: fiscal decentralization, enhancing audits, increasing availability of fiscal/budgetary

information, strategic and wider financial/development planning and broader regulatory frameworks that define the behaviours of both the public and private sectors in their involvement in the economy.

Notes

1. ECA (2016a, b).
2. http://www.eepco.gov.et/abouttheproject.php?pid=1
3. WFP (2012).
4. Fiscal space is a budgetary room that allows a given government to provide financial resources for a desired purpose (e.g. infrastructure) without any prejudice to the sustainability of a government's financing position.
5. PEFA (*Public Expenditure and Financial Accountability)* Framework is the dominant PFM diagnostic tool.
6. The relations between the budget deficit and the saving-investment can be written thus: G-T=S-I, where G is government expenditure, T taxes, S savings and I is investments. This closed economy formulations can be easily modified to take care of the open economy case.

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