

THE GLOBAL FINANCIAL CRISIS AND DOMESTIC RESOURCE MOBILIZATION IN AFRICA

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1. INTRODUCTION

The use of domestic resources for development purposes is becoming more and more important as access to foreign resources becomes increasingly difficult. It is the current global financial crisis and the subsequent recession that are generally expected to make access to foreign resources more difficult. Ironically, however, there are possibilities of the financial crisis also affecting the mobilization of domestic resources. “Domestic resource mobilization refers to the generation of savings from domestic resources and their allocation to socially productive investments” (Culpeper 2008). Such resource mobilization can come from both the public sector and the private sector. The public sector does this through taxation and other forms of public revenue generation. The private sector mobilizes resources through household and business savings, working through financial intermediaries to convert these into productive assets.

The global financial crisis will affect the capacity of the public sector to mobilize tax revenues if it affects the incomes of residents or has an impact on trade with outsiders which will affect trade taxes. It is observed that many African countries have pursued a number of reforms aimed at strengthening the mobilization of tax revenues. The introduction of such new taxes as VAT, the rationalization of trade tariffs, the strengthening of tax offices, the reform of incentive structures, reduction and removal of subsidies, etc. are some of the reforms associated with the fiscal sector in a number of countries with varied outcomes. In Ghana, for example, government revenues have increased steadily as a share of GDP over the last two decades at an average rate of 4 percent per annum. While this has happened public expenditures have also climbed steadily, albeit somewhat faster, leaving a growing deficit. The quality of such expenditures in delivering socially productive outcomes has been questioned (Killick 2008). The situation is not different in most countries.

Another significant challenge that African countries face is how to strengthen their financial systems in order to make them deliver the necessary financial resources to be used for boosting investments and facilitating employment creation. The last two decades have seen several reforms intended to deal with various bottlenecks in the system for the purpose. Most of the reforms have been designed to enhance the policy environment for financial institutions and provide incentives for them to become more competitive. They have also been intended to build the institutional capacity to handle the growing demand for different types of financial services coming from a more diversified clientele.

Despite the effort, studies of financial systems performance in most African countries over the last two decades have often suggested that the reforms have generally had

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limited success in effectively mobilizing domestic resources and channeling these into productive investments. Savings mobilization has been slow in many countries and lending to the private sector has always been problematic, especially for small borrowers. In some countries, weak financial systems have facilitated considerable capital flight to more modern economies. In trying to stem the problem, a number of countries have devoted considerable resources to strengthening regulatory regimes, with varied results coming out of the effort.

A number of studies into the problems of mobilizing domestic resources have focused on the nature and extent of financial development in the light of reforms. Niskanen and Aryeetey (2008) argued that the situation of difficult financial intermediation is the consequence of having fragmented financial markets which have difficulty minimizing transaction costs the way efficient markets do. As a result of the fragmentation, the different elements of the market serve different groups and interests and do not afford them the gains from a competitive market. The markets have difficulty mobilizing deposits from surplus units and making these available to deficit units. This is best reflected by the presence of many informal and semi-formal operators who are fairly independent of the formal financial system.

With the current global financial crisis, the view has generally been that since African financial markets were not closely integrated into global financial systems they would be spared the worst of the effects on financial markets. It is argued that African banks generally have African ownership and therefore the problems of the European and American banks are not likely to be transferred to the African banks through ownership structures. Even where there is some foreign ownership and this has increased with reforms, the assets and liabilities of these institutions are fairly well decoupled. Another argument has also been that African banks have limited exposure to the international financial markets. Their borrowing from these markets has been limited and they have not had much interaction with the so-called toxic assets of the foreign institutions. While these may very well be generally true, the fact also remains that the knowledge that they could borrow from international markets to supplement whatever resources were available to them from domestic markets encouraged African financial institutions to be a lot more out-going in terms of the development of new instruments in recent years. There is certainly a worry now that the banks would go back to their old ways, showing extremely little interest in new instruments and new clients, opting for safer government business only.

It is important to note that even if African institutional arrangements for the mobilization of domestic resources are not closely integrated into international arrangements, the various economic agents who use the financial systems may be affected by their own interaction with the international goods and other markets, which in turn would affect their incomes and hence their ability to engage with tax authorities and the financial systems as appropriate.

The global financial crisis is expected to reduce external inflows into African economies. FDI, aid, export earnings, remittances, etc. are all expected to be affected by the financial

crisis. Moreover, the crisis is making it more difficult and more expensive to attract private capital than before. Indeed it will require more effort to access the same level or even lower levels of external resources than before. There have been long held views that efforts to attract foreign resources always take away from initiatives to mobilize domestic resources for African development (Adam and O'Connell 1997). Hence, there is a growing concern that the search for external support in this period of challenges will lead to reduced attention to domestic resource mobilization. The main thrust of this paper therefore is essentially to show that while the direct effects of a financial crisis will not be immediately observed in a significant way in the functioning of African financial systems, despite the reduced flows, they will lead to a slowdown in the productive activities of African countries through their real sectors. In order to offset this reduced flow and also in order to promote long term growth and development through sustained production, it is essential that African countries mobilize additional domestic resources.

This paper on the impact of the global financial crisis essentially looks at trends in the mobilization of domestic resources focusing on savings mobilization and credit to the private sector, as well as the problems with the mobilization of taxes. The paper attempts to consider how the current global financial crisis affects the performance of African countries in these areas. It is argued that the effects of the crisis can be identified mostly through indirect channels. The paper then captures a number of suggestions that have been made for countries to mobilize domestic resources and then concludes.

2. THE PROBLEM WITH DOMESTIC RESOURCE MOBILIZATION IN AFRICA

The main problem with domestic resource mobilization in Africa has been that not enough savings are being generated to facilitate the required investment (Aryeetey 2004). Also, the types of savings available do not easily make financial intermediation possible. African countries' low and stagnant savings rates have not compared well with those of Asia, giving sub-Saharan Africa the lowest savings rate among the developing regions. The most available measure of savings performance is the gross domestic savings (GDS). GDS in Sub-Saharan Africa amounted to 17.6 percent of GDP in 2006, compared with 26.0 percent in South Asia, 24.0 percent in Latin America and the Caribbean, and nearly 42.9 percent in East Asia and Pacific countries (World Bank 2007) (See Figure 1). The much lower level of savings in Sub-Saharan Africa may explain much of the lower level of economic activity in the region and the slower pace of growth.

2.1 Trends in Savings Mobilization

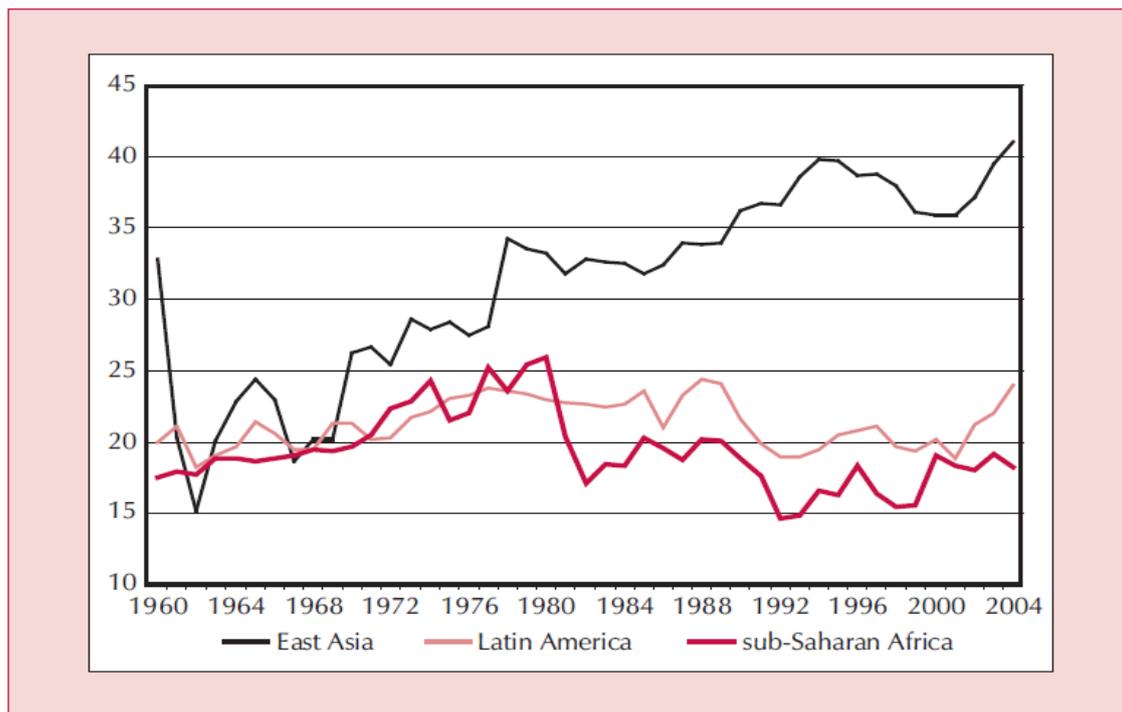
But the above low figures for SSA hide important differences across the region. While gross domestic savings in some parts of Africa were as low as -20 percent of GDP in 2005 (e.g. in Eritrea and Sao Tome and Principe), indicating dissavings, in other places, including Algeria and the Republic of Congo, domestic savings rates were as high as 50 percent of GDP (World Bank 2006). Angola experienced an average rate of growth for domestic savings of 28 percent in 1980-96 and Gabon with an average saving rate of 38

percent for the same period, and these rose to 40.6 percent and 55.4 percent respectively in 2007. The very high rates for the major oil exporting countries is not surprising in a region where most countries have domestic saving rates of less than 15 percent of GDP. Not surprisingly, in these high savings economies, the public sector tends to dominate savings.

The savings rate for Sub-Saharan Africa has broadly evolved over the years in the following pattern. From 1960 to 1974, it increased steadily from 17.5 percent to 24.3 percent of GDP (World Bank 2007). It then experienced much higher volatility before reaching its highest rate (nearly 26 percent) in 1980. In 1992, savings in Africa basically collapsed, reaching an all-time low of 15 percent and generally remained that way, albeit with a slight recovery at 17.6 percent in 2005 (World Bank 2007). Table 1 below shows the trend in saving rates in SSA for the period 2000-2005, with a majority of the countries showing very low rates.

Figure 1

Gross domestic savings by developing regions, 1960–2004
(Percentage of GDP)



Source: *World Development Indicators, 2007*

The savings trends for SSA diverge significantly from that of other developing regions, especially after 1980. While SSA saving rates have fallen, Latin America's have stagnated and East Asia's rates have soared (See Figure 1).

Table 1**Distribution of savings rates in Africa, 2000–2005***(Number of countries)*

Negative	0–10% of GDP	10–20% of GDP	20–30% of GDP	Over 30% of GDP
11	14	13	7	5

Source: World Development Indicators, 2007

Aside from saving rates, stability over time is crucial for smooth and predictable investment, and Africa again fares worse than other developing regions in this area. A major reason for this is the volatility of the sources of income, which is higher in Africa than in other developing regions, due mainly to exogenous shocks related to primary commodity dependence.

By and large, these trends reflect the economic performance of these regions over the past four decades or so. It is therefore not surprising that in Asia, most of the countries that were on a similar economic footing as sub-Saharan countries in the early 1960s, have made significant strides in their development, while sub-Saharan Africa has deteriorated.

Explaining the Low Saving Rates in Africa

A number of studies have been conducted in the last decade to explain low savings rates in Africa. There are those that have been done using macroeconomic approaches and the more micro-level analysis. An example of some of the earlier broad econometric work is that carried out by Hadjimichael et.al. (1995) who suggested that sustained reform programs and positive per capita growth generally led to faster growth of private savings. In those faster growing economies that they looked at, they measured a cumulative change of 5.7 percentage points between 1986 and 1993 of private savings as a share of GDP compared to –2.7 percentage points for slower reforming and growing economies in the region. Even though they argued that the maintenance of structural adjustment policies led to improvements in macroeconomic balances and low inflation, a number of other studies (including Nissanke and Aryeetey 1998), found little evidence of reforms having such an impact on savings performance. It is also interesting that the World Bank (1994) had earlier noted that there was little evidence that economic reforms in many African countries had had a major impact on savings and investments. Over the reform period, only a couple of serious reformers saw some modest improvements in their savings performance.

The Hadjimichael et.al (1995) study also suggested that increased official inflows led to improvements in government savings and investment as well as faster growth in private savings and investment in several of those countries. They used their empirical testing of the relationship between macroeconomic performance and growth, savings and investment to suggest that a conducive macroeconomic environment was necessary for growth, savings and investment. Despite what they saw as significant improvements in the countries they studied in SSA, they acknowledged that savings and investment ratios

in the region were “significantly lower than for other developing countries and still too low to support a sustainable expansion in output and employment” (pp.27).

Other macro studies include that of Mwegu (1997). He did a comparative analysis using life-cycle and permanent income intertemporal models of average private savings rates in 33 countries, including 15 African countries and found evidence that saving rates were generally lower than in other developing countries. He found a positive and highly significant coefficient on per capita income which decreased as income increased, a positive and highly significant coefficient on growth of per capita income, a negative and highly significant coefficient on public saving, a positive and highly significant coefficient on the degree of financial depth (M_2/GDP), and an insignificant coefficient on financial constraints. Focusing on the African countries alone, Mwegu (1997) shows that private savings is determined largely by the dependency ratio, level of per capita income, economic growth, terms of trade and public savings rates. His conclusion generally was that the low savings rate in Africa was a consequence of both the private savings function and initial economic conditions.

It is generally anticipated that terms of trade shocks will affect savings, and this is important to SSA, particularly in this time of a global crisis. Interestingly, the study by Hadjimichael et.al (1995) did not find any significant relationship between changes in the terms of trade and savings. Mwegu (1997) on the other hand found a significant negative relationship between terms of trade and savings.

The World Bank's (1994) study suggested that savings performance in SSA was driven largely by the performance of public savings. This was quite different from the situation that Srinivasan (1993) had reported about Asia. Following this observation, there have been discussions of whether the public sector tends to crowd out the private sector in SSA. Kelly and Mavrotas (2003) modeled the relationship between public and private savings and suggested that the two have a relationship that reflects Ricardian equivalence effects along the lines of Barro (1974) and Feldstein (1982). This finding is different from that by Hadjimichael et.al. (1995) who observed a strong positive relationship between them. In this case it is suggested that public investments generate private capital accumulation and economic growth through positive externalities. Aryeetey (2004) has argued that public savings and private savings have different effects on investments and this is more important in terms of employment creation. Considering that both are low in SSA, the desirable thing at this stage in SSA development is to have both growing and having their differentiated impacts on investment and employment.

It is usual to consider the link between demographic characteristics and savings by incorporating the dependency ratio into a model. Hadjimichael et.al. (1995) observed a strong negative relationship between the two. Mwegu (1997) also found that the dependency ratio had a significantly negative effect on private savings. It is reasonable however to argue that the issue of the link between the two is still far from settled.

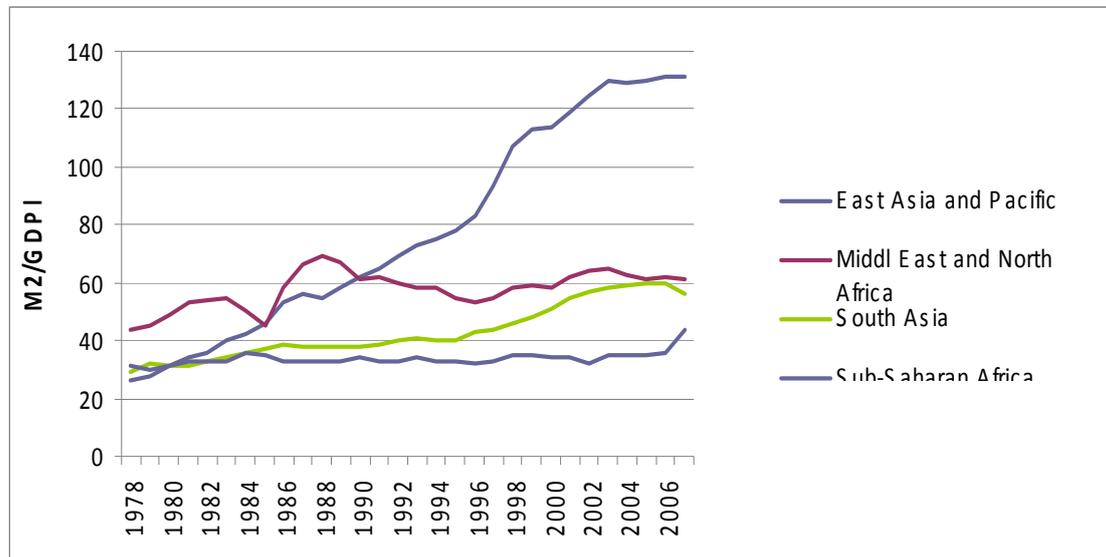
The study by Nissanke and Aryeetey (1998) presents one of the most comprehensive assessments of savings mobilization following liberalization of the financial system. The

fact that reforms did not lead to enhanced savings mobilization has also been observed by many others. They lead to a general conclusion that structural and institutional issues are very important for savings mobilization. Kelly and Mavrotas (2003) made the point that drawing any specific conclusions about how liberalization affects savings mobilization is futile since one has to consider the financial sector and its structures in totality. Nissanke and Aryeetey (1998) have discussed a number of structural and institutional constraints to the mobilization of savings, particularly from poor households. They suggest that financial markets in Africa are highly fragmented and that the high transaction costs for economic agents trying to move across different segments act as a disincentive in savings mobilization. They relate these structural features to various institutional constraints of the formal sector, noting, for example, that savings mobilization from rural areas is very costly and that banks in Africa have not been designed to counter this through innovative approaches in savings mobilization. The answer does not simply lie in having more rural outlets for commercial banks, as they indicate that rural savings mobilization is not necessarily positively correlated with the number of bank outlets. Indeed, many of the rural outlets turn out to be unsustainable, hence the tendency to close many of them with financial sector reforms. Nissanke and Aryeetey (1998) suggest that there have been few innovative savings instruments developed with a view to reaching untapped segments of the financial market.

There have also been quite a few attempts to explain savings behavior through micro analysis. Deaton (1997) worked on the life-cycle hypothesis using Ivorian LSS and Thai household data, looking at consumption and saving by cohorts. They showed hardly any evidence of life-cycle considerations for saving. His work showed that over the long-term, consumption and income were closely correlated. He observed consumption to be tracking income and leaving no evidence of life-cycle saving in Cote d'Ivoire. This observation is corroborated by the work of Collins (1991) whose work suggests that the motivations to save among poor people are the same in different regions. Since this does not adequately explain why African households save less than others, one might consider some of the earlier work of Deaton for explanation. Using a rule of thumb of households saving 20 percent-40 percent of incomes for consumption smoothing purposes, and with the understanding that credit markets influenced consumption smoothing significantly, he looks at data from Ghana, Cote d'Ivoire and Thailand. He observed that loan sizes were not large enough to play a significant role in consumption smoothing. Loans tended to be more important in the seasonal data. The work of Deaton (1992) and Udry (1990) suggest that the role of credit markets in influencing savings could only be moderate. There is a wider set of institutional impediments to savings mobilization that need to be rectified.

In the current situation, what is characteristic about households and their assets in SSA is the non-financial nature of these, as reflected by the relatively low M_2 /GDP ratios, even if they are beginning to improve (See Figure 2). A number of LSMS surveys carried out in several countries show household assets that are in excess of 30 percent of their incomes (Aryeetey and Udry 2000). In the case of Ghana, Aryeetey and Udry (2000) have shown that it is only among the wealthiest 10 percent of rural households that financial assets have some link with income changes. The study suggested financial assets become important only after a certain income threshold.

Figure 2: Financial Deepening, M₂/GDP Ratio



2.2 Credit Availability and Domestic Investment in SSA

The last two decades have seen a growing reliance by African countries on external resources to finance investments. With Gross Domestic Savings at over 25 percent of GDP in 1980 and Gross Domestic Investment at 22 percent of GDP, there was hardly a gap to be filled. Foreign direct investment came to only 0.7 percent of GDP. The East Asia and Pacific region invested 32 percent of GDP and saved 30 percent of GDP at the time. As savings figures have dropped in SSA, they have left a growing gap to be filled by foreign resources. But the period has also seen a significant decline in investments as shown by data on gross fixed capital formation in Table 2 below. The reality is that SSA countries are not investing as much as is necessary and most of the investment done has, for a long time, been with public resources. The very significant use of public investment would also explain why employment generation has not been a major outcome of the associated growth processes (Ndulu et.al 2008).

Table 2: Gross Fixed Capital Formation/GDP

Year	Sub-Saharan Africa
1980	22.2
1994	17.9
1995	18.4
1996	18.2
1997	17.7
1998	19
1999	18.4
2000	17
2001	17.9

2002	18.2
2003	18.6
2004	19.5
2005	19.4
1980-89	18.9
1990-99	17.7
2000-05	18.9

Source: African Development Indicators 2007-08, Tunis

Not surprisingly the low rate of investments, especially private investment, is attributed, even if partially only, to the dearth of credit to the private sector in SSA countries (Honohan and Beck 2007). Honohan and Beck (2007) show that by 2005 the claims that banks in SSA had on the private sector was less than 30 percent of their total assets compared to more than 60 percent in East Asia and the Pacific and also in South Asia. In Latin America this was almost 70 percent of total assets. The ratio of private credit to GDP was only about 18 percent in SSA in 2005. In South Asia this was as much as 30 percent. For the low-income countries in SSA the ratio of private credit to GDP falls to as low as 11 percent (Honohan and Beck 2007). African financial systems are reported to show a low intermediation ratio. This means they have a low share of deposits going into private sector credit.

Honohan and Beck (2007) also show that even though all indicators of financial depth indicate SSA to have the lowest achievements, there are signs that these have improved significantly in the last decade. The median value of real private sector credit has doubled in the period. As many as 80 percent of all SSA countries showed this improvement, and in Ghana credit to the private sector moved from 14 percent of GDP in 2000 to 27.4 percent in 2007. Honohan and Beck (2007) have suggested that the significant improvements in many countries suggest that there is a lot of room for further improvement simply by restructuring institutions. They use the Tanzanian situation to exemplify the potential after credit to the private sector moved up from 2.8 percent in 1996 to about 10 percent in 2005 following a restructuring of the largest bank. Clearly, despite the improvements there is still a significant gap between the performance of African banks and what has been achieved in other developing regions.

There are a number of explanations for the low level of credit to the private sector. These have been studied several times and many reasons have been assigned for the situation. Most of the explanations are related to the perceived high risk environment of SSA economies. Niskanke and Aryeetey (2008) have explained that with the fragmented nature of the financial systems, the flow of information across the different units is very limited thus making it difficult and costly for banks and other lenders to acquire the necessary useful information about potential clients. The fragmentation makes banking uncompetitive and inefficient. Information asymmetry is seen to be at the bottom of all lending decision making. Honohan and Beck (2007) explain that the problems of low competition and efficiency also have an effect on the interest rate margins, costs and profitability of banks. Banks are able to raise their profits largely by avoiding small

borrowers, about whom very little information may be found, and then concentrate on lending to public entities and other high net worth customers at premium rates.

But there have also been macroeconomic factors. Governments have used various monetary policy tools to control their economies. Borrowing extensively from the banking system to finance growing deficits has always pushed up interest rates that have effectively led to a rationing of credit to the private sector. But, until recently, the steady borrowing in many countries also contributed to rapid deterioration in inflation conditions which contributed to banks further raising their base rates.

In sum, SSA financial systems have a lot of difficulty mobilizing deposits and through intermediation, making these available to potential investors. The result is that very little of such investment in SSA is done with bank credit or other forms of credit.

2.3 Taxation and Public Investments

Tax revenue is a major domestic financial resource in all economies. Indeed taxes account for most of government revenue in the majority of African countries, but they do not generate enough, particularly when compared to other regions. The amount of tax revenue as a percentage of GDP in Africa was 22 percent in 2002 (World Bank 2005), which was far lower than the average for developed countries. The tax ratio is considerably lower in sub-Saharan Africa (20 percent) than in North Africa (25 percent). Furthermore, there are major differences among countries in the region with regard to their tax performance. Tax as a share of GDP in 2002 ranged from more than 38 percent in Algeria and Angola to less than 10 percent in Chad, Niger and Sudan (World Bank 2005). The tax-to-GDP ratio in a given economy is broadly determined by a set of structural features such as the per capita income, urbanization, literacy, the shares of the industrial, agricultural and mining sectors, as well as the level of trade. In sub-Saharan Africa, the main determinants of the tax-to-GDP ratio have been observed to be per capita income, trade levels, and the shares of agriculture and mining in the economy (World Bank 2005). Per capita income reflects not only the taxable capacity of the population; it also serves as an indicator for general development in an economy.

A recent study by Le et.al (2008) provides an interesting insight into how African countries are doing in the area of tax mobilization. They employed a cross-country approach to estimate tax capacity from a sample of 104 countries, including several African countries, for the period 1994-2003. They used their estimation results as benchmarks to compare taxable capacity and tax effort in the different countries. They defined taxable capacity as the predicted tax-GDP ratio that could be estimated with the regression, after taking into account a country's specific economic, demographic, and institutional features. They also defined tax effort as an index of the ratio between the share of the actual tax collection in gross domestic product and the predicted taxable capacity. Following this they classified countries into four groups by their level of actual tax collection and attained tax effort². The analysis provides guidance for countries with various levels of tax collection and tax effort.

² The classification was based on the benchmark of the global average of tax collection and a tax effort index of 1 when tax collection is exactly the same as the estimated taxable capacity.

Interestingly most of the African countries in the sample fell into two categories, namely Group 1: Low Collection and Low Effort and Group 2: Low Collection and High Effort. Countries in the first group were mainly from the developing world, and about 75 percent of them were ranked as low-income or lower-middle-income countries. The majority of them were observed to have several problems in both tax policy and tax administration. Some of them including Cameroon and Madagascar were mentioned as having “their tax policies riddled with overly complex structures and multiple—largely ad-hoc—incentives that narrow the already limited tax base, create more loopholes for tax avoidance and evasion, intensify the public perception of unfairness of taxes, and generate opportunity for corruption”. The researchers report that some countries have opted to retain generous tax incentives to compensate for their relatively high statutory rates on corporate income in order to attract private foreign capital. An example mentioned in the study is Cameroon but this could easily have been many other countries. The researchers suggest that “such complex tax regimes combined with the existing weak revenue administration capacity have led to chronic low tax collection at high administrative and compliance costs”.

For the countries listed in the Low Collection and High Effort group, there is still a large number of African countries, including Cote d’Ivoire, Ethiopia, Ghana, Kenya, Senegal, Uganda and Zambia. Le et.al (2008) noted that in these countries, “administration capacity is notably low and the tax regime is highly unstable. They have low collections, whereas high tax efforts are usually achieved by either enforcing easy taxes (particular trade taxes) or imposing high taxes on the formal sector, or both. Uganda is the case in point”. Uganda’s tax system is reported to be one that could be considered as a significant impediment to investment and formality (Chen, et al. 2001). It is noted that revenue collection has stagnated at about 12 percent since the early 2000s. In describing the recent tax policy reform strategies, they are noted have been largely inconsistent with an increase of statutory rates in some major taxes at the same time as an introduction of new exemptions and zero rates in the VAT. Uganda is reported to rely heavily on distorting trade taxes. As in many other countries “a high tax burden is imposed on a limited number of taxpayers, and medium sized firms which already bear disproportionately high share of taxes (Gauthier, et al. 2006).

There have been a number of studies into why taxation is difficult in African economies. Fjeldstad and Rakner (2003) have argued that “most sub-Saharan countries face a trilemma with respect to taxation: (1) There is an urgent and obvious need for more revenues to enable resource poor states to provide and maintain even the most basic public services. (2) The reality is, however, that those with political power and economic ability are few and do not want to pay tax. (3) Moreover, those without political power are many, have almost nothing to tax, and do also resist paying taxes”. In light of these general difficulties, the challenge that governments in the region face is how “to raise domestic revenues from consenting citizens in poor and increasingly open economies”. Fjelstad and Rakner (2003) believe that as governments increasingly become elected they have to confront the “hard choices about taxation”. In weak democracies it is very difficult to introduce new taxes without fear of difficult political repercussions.

Fjeldstad and Rakner (2003) further suggest that tax systems may be assessed using a number of criteria, including the ability to raise revenues, effects on economic efficiency, equity implications and administrative feasibility. Based on these criteria they assess tax

systems in many African countries to be scoring low on most. They argue that the weaknesses are partially derived from the nature of the reforms that have been pursued in light of structural adjustment. “In most cases this involves the introduction of measures to (broaden) the tax base while simultaneously flattening the tax rates”, just as is generally the case in more advanced countries. It is argued that the socio-cultural characteristics of environments do not appear to have been taken into account in these reforms. The reforms have generally involved the following:

- introduction of the value-added tax;
- lower personal and corporate income taxes;
- simplification of the tax bands and broadening of the bases for personal and corporate income taxes;
- reduction of import duties and simplification of the rate structure;
- simplification of the excise duty structure; and
- abolition of export taxes.

In spite of the reforms, it is assessed that tax systems in many African countries currently “show an excessive number of different taxes with rate structures that are difficult for taxpayers to understand”. Fjelstad and Rakner (2003) suggest that the language used in tax laws is usually confusing and there are no manuals to be consulted. The consequence is that they generally lead to considerable discretionary powers for tax enforcers, including several related to the provision of tax exemptions, determination of tax liabilities, selection of audits, litigation, etc. They further suggest that a number of administrative procedures, including the procedures for reporting tax revenues, lack transparency and are difficult to monitor. The result is that tax systems are complicated and lack transparency. These views about the tax systems in SSA are not very different from those of Adam and O’Connell (1997) who have suggested that tax distortions have been high and volatile in Africa. They have pointed out that poor systems influence the allocation of national wealth and they can reduce both the level and productivity of domestic investment. For them, however, the poor composition of domestic investment may be more important in explaining poor growth in the region than the level of domestic investment.

The difficulties of the tax system are not only found at the national level. They are even more difficult at the local government level. In the study by Fjelstad and Rakner (2003) they conclude that many local taxes tend to have “a distorting effect on resource allocation decisions, and an inhibiting effect on the start-up of new enterprises”. They argue that these effects come about as a result of the considerable variation in effective tax rates between different goods that are traded. They indicate that license fees tend to be too high for small enterprises that are beginning operations, and this is a major disincentive for local businesses. Local taxes are assessed to lead to a higher tax burden on the poor than on the non-poor. A difficult local government tax system is not only costly but is seen to ease corruption and encourage mismanagement.

Adam and O’Connell (1997) have looked at how taxes in SSA impact different sectors of the economy. They observe that while taxes on international trade are administratively

easy to collect they tend to make up a declining share of total revenues as per capita income rises. International trade taxes accounted for an average of 35 percent of total revenues in the mid-1980s, as compared with 23 and 17 percent in Asia and Latin America/ Caribbean. SSA has been associated with high average tax rates on African trade. Thus, despite declining tariffs in the wake of trade liberalization in the mid-1980s, the median tax rate for SSA still exceeded that for other developing countries by 50 percent. Adam and O'Connell (1997) also argue that, real exchange rate overvaluation provides a measure of the implicit taxation of export-oriented production in favor of production for the home market. "The overvaluation "tax" on exporters is additional to that implied by low producer prices paid by monopsony national marketing boards."

Another area of major taxation is the agricultural sector which has been assessed by Adam and O'Connell (1997) to have also faced an "unusually heavy tax burden in some African countries". Schiff and Valdes (1991) reported from a study of 26 commodities that a combination of export taxes, low producer prices, protection of manufactured inputs, and exchange rate overvaluation produced an average nominal protection rate of -52 percent for the three African countries in the sample (Cote d'Ivoire, Ghana and Zambia). For the other 15 developing countries in the sample, this was only -30 percent.

In effect, the capacity of African economies to mobilize domestic resources through taxation is not only hampered by widespread poverty, but largely a consequence of institutional failures that need to be addressed.

3. THE FINANCIAL CRISIS AND DOMESTIC RESOURCE MOBILIZATION IN AFRICA

The discussion in section two suggests quite clearly that savings mobilization and lending by banks in most African countries have relatively little to do with the performance of global financial markets, but more with how they are organized. But before the crisis began, the global financial markets were beginning to exert some influence on resource mobilization in SSA by increasingly providing standards that could be used to measure the performance of financial institutions. For example, in the wake of the Asian crisis in 1997, the resulting tightening of standards and regulations in financial markets throughout the world was also extended to financial institutions in SSA. The adoption of the International Financial Reporting Standards (IFRS) by banks in the region was significant in this regard. After the improvements in the regulatory environment for African institutions, there emerged the beginnings of interaction between the financial markets of African economies and those in Europe. A few African governments began to issue sovereign bonds in 2007 that were assigned through consortia of local and international financial institutions, and this development was generally seen as marking a new entrance onto the global financial system. While that development may have been curtailed as a result of the global financial crisis, even more important was the fact that banking in Africa was being modeled increasingly along those of banks in advanced economies. This may be lost with the financial crisis. This section of the paper discusses

what developments there have been in savings mobilization and lending by African banking systems since the crisis broke, using developments from a handful of African banking systems for illustrative purposes only.

3.1 The Crisis and Savings Mobilization

In the absence of aggregated data that will show the flow of savings in the period since the crisis broke the paper relies here on data and reports from a few of African central banks with relevant information on the performance of savings.

The Bank of Ghana (2009) has indicated that at the end of the last quarter of 2008, total deposits of the banking system stood at GH¢6,949 million which was 65 percent of total liabilities compared to 63 percent in 2007. Also in the last quarter of 2008 there was an increase of 11.4 percent in the total deposits of the banking system over the previous quarter's figures and this compares with an increase of 14.3 percent over the same period in 2007. The difference in the rate of increase in the last quarter of both years is judged to be not statistically significant. What is interesting about the growth of deposits in the Ghanaian banking system in 2008 is that it occurred when the share of total borrowings in the banks' liabilities declined by 0.8 percentage points. The share of shareholders' funds in the liabilities did not change in the period, remaining at 10.4 percent. Thus, deposits have remained fairly robust even if the banking system's holding of deposits is not very widespread.

In Nigeria the Monetary Policy Committee of the Central Bank of Nigeria met in December 2008 and reported that broad money growth had moderated somewhat in the last quarter based on figures up to the end of October 2008. In Kenya, the Governor of central bank has recently reported that the global crisis has not affected significantly the performance of the banking system, and so indeed have similar reports from the Bank of Tanzania. It is safe to conclude that central banks in the region do not anticipate any major changes in the savings outcomes as a result of the crisis.

It is not surprising that savings outcomes are not expected to change. This is because, as earlier pointed out, the issues relating to savings and deposits are more of an institutional and structural nature, after having dealt with many of the policy issues through financial sector reform programs. The factors that impact most on savings have not been affected yet by the global crisis, and this situation will not change much in the very near future. What this means is that the low savings in the region cannot be immediately blamed on the crisis directly. On the other hand if it should lead to deterioration of household incomes in the future, as well as in the profits of private enterprises, there is every reason to expect that the holding of financial assets will be reduced.

3.2 The Financial Crisis and Credit Availability

The picture with the availability of credit is quite similar to that of deposits mobilization. There is no real indication of a discernible change in the usual pattern. For instance, the Bank of Ghana has reported that the last three months of 2008 saw a tightening of credit

supply by banks. More than 35 percent of banks reported such tightening in December compared to just over 25 percent in October. The main reason for the new stance was the rising cost of funds and the changing expectations about economic activity in the country. The data showed that in the last quarter of 2008 the availability of credit to small and medium sized enterprises increased but the increase was smaller than it was in the third quarter. The difference was, however marginal.

Unlike SMEs, credit to households for house purchase in Ghana declined significantly in the last quarter of 2008 and this was attributed by banks to concerns about the economic outlook. Even though households received more consumer credit in the last quarter, the increase was less than had been observed in the third and earlier quarters in the year. The central bank in Ghana argues that the net easing of consumer credit could be attributed to competition among banks. What is also interesting is the fact that the number of applications being presented to banks for loans also went down in the last quarter, particularly for SMEs. On the other hand larger enterprises submitted more applications in the last quarter than they had previously done. Not surprisingly, the demand for long term loans dropped significantly in the last quarter. What the above picture signifies is a mixed bag of developments with no clear pattern emerging. While the drop in demand for long-term credit may be significant, it is associated more with firms' views about global demand for their products as exporters than with the global financial crisis itself. Many of these were exporting firms, thus confirming the idea that any links between domestic resource mobilization and the global financial crisis works more directly through the changes in the real economy worldwide. It is also noteworthy that interest rates began to rise much faster in the last quarter largely in response to worsening macroeconomic conditions.

In Kenya, the flow of credit to the private sector increased by 7.4 percent in the third quarter of 2008 but this dropped to 2.5 percent in the last quarter. In the second quarter the growth had been 5.2 percent. The ups and downs in the flow in 2008 are not comparable to the situation in 2007. In the last quarter of 2007 the growth of credit to the private sector was as high as 9.6 percent compared to the third quarter increase of 3.9 percent. The 2007 trends were more like what had been observed in earlier years. Thus, clearly the sharp drop in credit flow to the private sector in the last quarter of 2008 stood out.

For many African countries, the story appears to be quite mixed on the credit front. Banks appear to have generally reduced credit supply in the last quarter of 2008, in particular for SMEs and households as they expected more difficult economic conditions in the face of a growing global financial crisis. This is in spite of the fact that households dominate the receipt of credit from the banking systems.

In Nigeria, the report of the Monetary Policy Committee of the Central Bank of Nigeria in December 2008 observed that the "growth in M_2 has continued to be driven mainly by credit to the core private sector, which grew by 52.5 percent (or 63.3 percent annualized) as at end-October 2008". Again what is referred to as the core private sector is the group of larger enterprises that continued to receive credit in other countries also. The growth in

credit was also reflected by the larger profitability of banks in Nigeria as the MPC of the central bank noted that “whereas many banks abroad have been making losses and faced with potential bankruptcies, Nigerian banks have in fact been posting profits”.

3.3 The Financial Crisis and Tax Revenues

The situation with tax revenues in most countries is not expected to have changed much in the wake of the crisis but the financial crisis will affect tax revenues in the medium term by affecting their determinants. Generally, tax revenues are expected to fall given that the total revenues depend on the level of income and economic activities. The financial crisis is expected to reduce Africa’s GDP growth to only 3.25 percent in 2009, depress trade and diminish investment by corporate entities. This means that if tax rates (income tax rate, consumption tax rate, corporate tax rate and trade tax rate) remain at the current levels, the amount of revenue collection for 2009 and beyond by governments would decline.

The implication is that in the face of the global financial crisis, many African countries will have to significantly improve their tax effort in order to maintain the same level of revenue collection. More importantly, the countries will have to ensure high efficiency of government spending since it is an essential part of making domestic resources the engine of development. With the financial crisis in full swing, the opportunity cost of each unit of spending is very high.

In Ghana figures published by the government suggest that tax revenue exceeded the target significantly. Total tax revenue in 2008 was about 24.4 percent of GDP and was almost 30 percent higher than in 2007. Of this, direct taxes, made up of personal income tax, company tax, etc. constituted 29 percent of total tax revenue and exceeded the target by 11.7 percent. Government attributed the better than expected performance to the introduction of a new pay-as-you-earn arrangement for personal income taxes. Interestingly, international trade taxes yielded an amount that was less than the target but exceeded the figure for 2007. Other taxes that saw drops in their intake include petroleum tax that yielded less than the outturn for 2007 and was 21.2 percent less than budgeted. This has been attributed to a reduction in the rate in the wake of the petroleum price rises earlier.

In Kenya, tax revenue increased by 14.3 percent between 2007 and 2008. The increase was driven largely by the almost 18 percent increase in income tax. The slowest growth came from import duties and excise duties. It stands to reason that incomes had not been necessarily affected in 2008 and this would explain why income taxes rose significantly in the absence of any changes in the rates.

As earlier suggested, the main problem with tax systems in Africa remains the fact that the governments are focusing on reforms that ensure larger and larger collections from the same sources and little effort to enlarge the net and to rationalize the taxes.

4. AFRICAN RESPONSES TO GLOBAL FINANCIAL CRISIS AND IMPLICATIONS FOR DOMESTIC RESOURCE MOBILIZATION

Sub-Saharan African governments generally recognize the fact that they are likely to be affected significantly by the fact that what began as a financial crisis has turned into a significant global economic crisis and sharp drops in demand. The effect on most domestic resources, as seen above, will come largely through indirect channels or not through the first-round effects. But African institutions have generally recognized the point that when the impact is felt in the real sectors of their economies, the effects could be long-lasting and have greater consequences for long-term growth and development than would be the case elsewhere.

At the meeting of the Committee of Finance Ministers and Central Bank Governors held in Cape Town in January 2009, the point was made that trade receipts would suffer significantly as importers of African goods went into a recession. Additionally trade financing was expected to decline sharply as the private agents who handled and financed trade experienced increasing difficulty in accessing their financiers. Private foreign investments were also expected to decline significantly as such investors found it more and more difficult to access funds in European and US banks and other capital markets. It was recognized that remittances will decline significantly as many more African migrants lost their jobs in the downsizing and restructuring of European and US companies. It was anticipated that the developed world might adopt protectionist positions and also renege on commitments to provide development assistance. The meeting was told that “The major concern in terms of the impact of the financial crisis on the real economy is the adverse effect on domestic demand, namely consumption, investment, exports and government spending. Any substantial decline in domestic demand will reduce income which will in turn affect employment and consequently growth”. It was anticipated that any worsening of the situation would have negative consequences for poverty reduction.

One of the meeting’s major recommendations was for African governments to increasingly turn to the use of domestic resources. It was noted that the low level of financial development necessitated financial sector and fiscal reforms in order to raise the levels of domestic resource mobilization. Such a reform was regarded to be essential to improving the internal conditions for mobilizing resources for development from within. The ministers considered the need for the establishment of property rights, contract enforcement mechanisms, and laws ensuring creditors rights. Finding ways to make bank supervision staff supportive of SME lending were suggested in view of the likely impact on employment generation. Other issues discussed included the need for an efficient domestic bond market, broadening of the tax base as well as the introduction of funded pension schemes. It was further suggested that public financial management should be a part of the package for mobilizing domestic resources as it leads to greater resource efficiency.

Since that meeting, there have been a number of conferences and meetings both at the regional level and at country levels to discuss possible ways of dealing with the issues. The most notable of these has been the adjustment of the conference organized by the

Government of Tanzania and the International Monetary Fund in Dar es Salaam to discuss the long term growth options for Africa to consider also more pressing matters in the light of the financial crisis and global recession. As at other meetings, the need for greater attention to domestic resource mobilization was noted.

What is problematic for many SSA countries is the fact that the shock to their economies from the crisis is occurring at a time when they have significant macroeconomic difficulties. In Ghana, for example, a deficit of 14.9 percent of GDP has been large enough to derail most of the gains from faster growth experienced in the previous six years. Inflation has jumped from 12 percent from two years ago to more than 23 percent. While the new budget for 2009 seeks to tackle the size of the deficit by reducing it to 9.4 percent of GDP in 2009, the question this leaves is what will such a large reduction in public spending mean for aggregate demand at a time when the need to create employment is probably more acute than ever before. This epitomizes the dilemma that many SSA governments face. The challenge is how to stabilize the economies adequately while stimulating parts of the economy to yield improvements in production and productivity and also employ more and more people.

5. MOVING FORWARD: MOBILIZING DOMESTIC RESOURCES TO COUNTER FINANCIAL CRISIS

As noted earlier, it has long been recognized that there are significant tradeoffs between domestic resource mobilization and other sources of financing development such as FDI, trade promotion, aid, etc. While they ideally may complement one another, the various sources of funding could also compete with another for attention and policy space, leading to the situation in which initiatives in one area may impact negatively on other areas. For example, high levels of aid may negatively impact domestic resource mobilization by reducing recipient countries' tax effort. In fact, the literature on the negative effect of increasing aid on tax effort in developing countries continues to grow (see Adam and O'Connell 1997).

Unbridled trade liberalization is expected to accelerate competitiveness and increase export earnings, though it has often resulted in reduced production and export capacities, even in the medium-term, apart from reducing government revenues. This is particularly the case in poor countries that rely heavily on tariffs as a revenue source. In such countries, only a very small share of revenues lost – due to tariff reduction – have been offset by wider indirect taxation instruments, such as the VAT.

There are also potential tradeoffs between domestic resource mobilization and a proactive policy to attract FDI or stimulate investment more generally, if such efforts include tax holidays, reduced royalties and other incentives for foreign investors. Poor countries offering such incentives incur huge opportunity costs in the form of foregone revenues. As a result, many are renegotiating royalty and revenue-sharing arrangements with foreign investors to garner a more significant share of the income generated by FDI.

The need to raise domestic resource mobilization efforts in Africa has become very obvious in view of the fact that the crisis will depress external inflows and possibly have a negative impact on some domestic resources. It however appears more prudent, especially in the medium to long term, for Africa to expend much more effort on domestic resource mobilization than on external inflows which are unreliable, volatile and may come with many strings attached.

5.1 Enhancing Savings Mobilization and Lending

The earlier discussions suggest that trying to boost savings in Africa requires effort to tackle the structural and institutional problems associated with savings. The first challenge is how to provide incentives for individuals and households to hold more financial assets.

Making Households and Individuals Hold More Financial Assets

Aryeetey (2004) has noted that agricultural production cycles and the risky environment within which many people live create a need for liquidity. Asset choice reflects returns on different assets, the covariance structure of risks associated with them, liquidity constraints, transaction costs, and production interactions between the different assets. The choice may also be affected by the cultural, demographic and other socio-economic characteristics of communities. This need for liquidity puts a premium on relatively liquid assets, often dictated by the seasonality of agricultural activity and the associated rural household income.

Interest rates may be important but the dominance of non-financial assets in household portfolios may not be a simple consequence of low expected returns to holding financial assets. Various studies of saving in sub-Saharan Africa have come up with inconclusive evidence of how interest rates influence saving (Mwega et.al. 1990, Oshikoya 1992). It is believed that pervasive market failures in SSA make interest rates inappropriate tools for measuring preferences. "Market failure forces the return on other assets to assume a greater role in asset allocation" (Aryeetey 2004).

Households and individuals face a number of options as they consider whether or not to put wealth into particular assets. These come with costs that may be considered to be intrinsic to the transaction, for example, incomplete information. If the nature of information possessed by depositors and deposit-takers as well as contract enforcement possibilities on the financial markets are different a problem could result. "If the transaction cost of holding a financial asset is perceived to be too high because there are no credible institutions, other assets would be given a preference" (Aryeetey 2004).

Trying to deal with these structural issues can be costly for governments. The following may be considered. (See Aryeetey 2004).

- Reduce the risks associated with rural production (e.g. seasonality of rainfall) possibly through improved irrigation and other infrastructure, and technology application. This will reduce significantly the higher liquidity preference of households, at the same time

that incomes go up in the medium term. Credit is often useful for reducing the idiosyncratic risks of poor households.

- Stabilize the macroeconomic environment that ensures that the returns on financial assets are relatively stable and predictable.
- Reduce the transaction costs of holding financial assets. Developing institutions that are not too far away from rural households and yet are cost-effective is the most sensible thing to do. This is what makes appropriate forms of microfinance essential.

Strengthening the Banking System

The recent study by Honohan and Beck (2007) on “Making Finance Work for Africa” provides very useful material on how best the banking system can be made to facilitate the flow of resources to investors and to poor households and small businesses. They emphasize the need for them to contribute to growth and stability, improve contract enforcement and transparency of information and also how governments cannot be the source of long-term funds. They also emphasize the need for a stable macroeconomic environment.

In pursuing an improvement of the banking system’s ability to intermediate funds, Honohan and Beck (2007) provide for ways to improve bank lending capacity and the enhancement of contract enforcement. The role of prudential regulation in all of this is very much emphasized. On how to improve bank lending capacity, they argue that the problem is not a lack of mobilized funds, which is a point that Nissanke and Aryeetey (1998) made a decade earlier. The problem of perceived liquidity risk is seen to be huge at the same time as bankers complain of a dearth of bankable projects. Honohan and Beck (2007) conclude that “lack of bankability is likely the more acute and intractable problem” (p.74). It would appear that the absence of reliable information about projects is one of the main obstacles to identifying bankable projects. Not being able to lend takes away the enthusiasm of banks to mobilize deposits. A solution that is proposed for this problem is to set up credit reference bureaus in various countries that will provide the kind of information needed to make sound judgments for projects.

Nissanke and Aryeetey (1998) go well beyond the proposals from Honohan and Beck (2007) when they propose that the solution to the structural and institutional problems facing African financial systems can best be solved using an integrated approach. They agree that a sound macroeconomic environment is essential to get a decent financial system going. They argue that most of the liberalization pursuits of two decades ago were premature since macroeconomic stability and a prudential regulatory and supervisory framework were missing. They suggested that having dealt with these two significant policy and institutional development issues effort must be made to remove the fragmentation of the financial systems. In doing that the following are seen to be essential:

1. Measures to deepen financial markets in the context of alternative institutional arrangements;
2. Measures to strengthen market-supporting financial infrastructure;
3. A new regulatory and incentive framework to advance market integration;
4. Measures to improve the financial technology of both informal and formal finance to widen the scope of their operations; and

5. Measures to develop linkages among segments.

In terms of financial market deepening, Nissanke and Aryeetey (1998) support the development of capital markets as an extension to the system that will facilitate alternative financial instruments for potential users of the system. Having different types of financial institutions competing for different types of clients appeared to them to offer opportunities for greater competition. This is a view that is generally very valid. While the presence of thinly traded capital markets have not necessarily solved the problems of potential users of capital, there is ample evidence that increased competition from non-bank institutions in a number of countries is forcing banks to pay greater attention to their businesses (Honohan and Beck 2007).

Market-supporting financial infrastructure includes structures that enhance the information base and the legal system. “Our research findings suggest that difficulties in obtaining reliable information and managing risks cause fragmentation” (Nissanke and Aryeetey 1998). The use of well-equipped credit reference bureaus is one of the means suggested to attain this end. Essentially countries must invest in enhancing the information capital base of their economies. While the more structured economies, as in South Africa, have such bureaus, a number of other countries have only recently initiated steps to set up credit reference bureaus, as in Ghana. These are still being worked on. Most other countries are yet to take the first steps. In terms of the legal infrastructure, the idea is basically to create institutions that help safeguard property rights and support the enforcement of contracts. An example of how some countries are dealing with it is to set up commercial courts after tightening laws on commercial contracts. “A special commercial court established in Tanzania was greeted with enthusiasm, though—perhaps inevitably—early achievements were not fully maintained. In Rwanda the time taken to resolve a dispute fell by 22 percent following the introduction of a specialized court for business, financial, and tax matters (Honohan and Beck 2007). But the issue of legal infrastructure is larger than simply establishing commercial courts. There are questions about what measures can be put in place to facilitate “taking collateral in forms other than landed property, not only because land title remain uncertain or not transferable in many countries but because few small borrowers possess land” (Nissanke and Aryeetey 1998).

On the need for new regulatory and incentive frameworks that advance market integration the challenge will be how to use regulation to encourage formal banks to reassess their relationships with non-banks. The growing use of microfinance institutions by banks is an example of how such integration can be arranged (see below). As the regulatory authorities develop greater responsibility for non-banks it becomes a lot easier for banks to work with them.

In seeking to achieve integrated financial systems, the use of appropriate financial technology is important. This refers to the processes through which deposit takers and lenders gather information and process these in decision making. With improved technology it is possible to reduce the transaction cost involved in such processing. Today, the use of computers and mobile phones, for example, has introduced a new dimension to reaching small depositors and borrowers in a number of countries and sharing information about

them. The M-Pesa project in Kenya for money transfers for example, creates another opportunity for people to be reached with money. The challenge is how to use these new technologies in a more structured manner for financial intermediation and for the delivery of a broader set of financial services.

In the proposals for enhancing financial technology, Nissanke and Aryeetey (1998) focused on devolution of decision-making and supervision to local levels; the increased application of character-based credit-worthiness criteria for small enterprises instead of project-based criteria; use of information possessed by informal and semi-formal financial operatives; and the use of non-bank institutions in screening and preparing SME loans application. The study of banks and microfinance in South Asia shows how such arrangements have worked and these are being considered by many African banks.

Developing Capital Markets

One of the biggest challenges facing the financial systems in SSA is the availability of long term finance. In the past this came from the governments in view of the inability of commercial banks to deliver them. Governments created development finance institutions (DFIs) to mobilize largely public resources and channel them to long term projects. After their difficulties of two decades ago, development finance has become extremely difficult to find. In their place many have seen the development of capital markets as the solution to the problems of term finance.

While capital markets offer many new opportunities to businesses in Africa their introduction to the region has not been without its problems. Of the 15 countries that had stock markets in 2005, only Nigeria and South Africa had more than 100 firms listed. The remaining countries had an average of 24 firms listed. The more worrying aspect of their development is the thinness of trading. With the exception of South Africa, the value traded is less than 3 percent of GDP in all countries; indeed in most countries, less than 1 percent of GDP. They obviously have difficulty mobilizing capital. Aryeetey and Senbet (2005) have suggested that in order to enhance the capacity of the fledgling capital markets to attract private capital, it is important that steps are taken to address the following:

a) Public Confidence and Informational Efficiency: Public confidence is fostered by an even playing field, with strict enforcement of existing rules. There ought to be an independent judiciary strongly enforcing and protecting rights. The government's role is vital in this regard in ensuring enforceability of private contracts and accounting procedures and legal standards.

b) Efficient Capital Market Regulation: At the heart of capital market regulation is investor protection, particularly small participants in the market. Small investors need to be properly protected through strict enforcement of securities laws and regulations. African stock markets can harmonize laws and regulations toward international standards. Government regulation of securities markets should be more of an oversight function over self-regulatory agencies, such as the stock exchanges and brokerage industry.

c) Capital Market-Based Privatization: Capital markets can be an important avenue for privatization. Such programs obviously contribute to the depth of the stock markets through increased supply of listed companies. Capital market-based privatization provides an improved chance of fair pricing of the enterprises, and hence serves as an important means of de-politicizing the privatization process. In addition, privatization through local capital markets allows for local investor participation and hence enhanced diversity of ownership of the economy's resources.

d) Regionalization of Capital Markets: One way to address the thinness and illiquidity of African capital markets is for the various countries to pool resources for regional co-operation and capital market development. Regionalization of African stock markets should enhance mobilization of both domestic and global financial resources to fund regional companies, while injecting more liquidity into the markets. The francophone example is worth looking at.

e) Human Capital Development: Global capital markets have become highly sophisticated in recent years with the advancing information technology. They are increasingly characterized by advanced and exotic securities, including a variety of derivative securities, demanding that market participants stay abreast of recent developments in financial theory and practice. Adequately trained financial manpower should be at the centre of capital market development in Africa.

Developing Microfinance

In the last decade microfinance has come to be regarded as a central part of developing country financial systems, even if little progress has been achieved in terms of what regulatory environment works best for delivering its services and protecting stakeholders. It has been shown to be effective in delivering financial services to small depositors and borrowers, and this has contributed significantly to enhanced domestic resource mobilization. There is also evidence of growing links between formal banks and microfinance institutions (MFIs) and that this link holds the key to expanding access to microfinance services. It is becoming commonplace throughout Africa to see banks set up microfinance operations either from within or in partnership with MFIs. In Aryeetey (2004) the argument was made that banks and microfinance institutions (MFIs) that engaged in microfinance were most effective and efficient if they adopted decentralized structures. This allowed them to reach marginal clients cost-effectively. Decentralization involves the maintenance of lean structures, accountability and incentives for increasing operational efficiency, streamlining of operations, and outsourcing and networking [See Wisniwski and Hannig, (1998)].

Wisniwski and Hannig (1998) have several examples of how maintaining lean structures can lead to substantial reductions in administrative costs for banks and MFIs. This can be done while taking care of essential aspects of the business of providing financial services. Banks that want to pursue microfinance must have staff members that have above-average information to be used for making appropriate decisions, regardless of how far away they are from the centre. This can best be done with careful selection and training

of staff and adapting deposit products to the programs' target clientele, in order to build a sustainable microfinance program.

When banks get involved in microfinance, in terms of accountability and incentives for increasing operational efficiency, the idea behind the creation of profit-centers within them is that those centers will not be over-burdened with the additional costs of the main organization (Wisniwski and Hannig 1998). The centers are expected provide transparency of costs. Aryeetey (2004) reports how recent innovations in Ghanaian rural banking offer some useful insights into how these are organized. The Atwima-Kwanwoma Rural Bank has made considerable effort to introduce *susu* operations³ as a cost centre within its operations, something that it learned from the informal sector. The daily contact with clients and potential clients make possible easy marketing of the bank's products to several thousand people on a regular basis. The bank was able to expand client base by more than 100 percent in a year.

Modern technology can facilitate reaching out to marginal borrowers. In Aryeetey (2004) we report how the use of modern technology to reach small depositors has been successfully done by Standard Bank of South Africa. "The development of the facility was facilitated by the fact that the high costs of the ATM infrastructure ensure that the product's fees are prohibitive for the poor. Trying to contain the cost enabled Standard Bank to develop a new electronic product to reach a lower income group than any other banks had previously. Having first set up a "downgraded" service, the bank later brought its E-Bank back into the main organization". This has been assessed to be highly successful (Aryeetey 2004).

Outsourcing of microfinance operations by banks and networking with other service providers has been shown to yield considerable mileage. It generally involves handing over key functions to other agents with greater experience and structures, and who have access to better information. The use of self-help groups is a possibility for achieving this arrangement. The experience of NABARD in India is insightful for discussions of the use of decentralized and effective institutions.

Developing Other Structural Features of Financial Systems

There are questions about how best African banks can be organized in order to enhance their capacity to deliver credit and other financial services to small businesses. Issues about ownership of banks and the size of banks have been raised by Honohan and Beck (2007) with respect to how these may be structured to make them more effective in the mobilization of domestic resources.

One of the most interesting developments in the last decade has been the increase in cross-border operations of African banks as they seek to consolidate. South African banks initially took the lead in reaching out to other countries. Nigerian banks have become very well known lately for their operations in several countries. There are over 30 banks in Africa today that have a presence in more than one country (Honohan and

³ Mobile banking done very informally with savings collectors who go to clients daily for deposits.

Beck 2007). It is acknowledged that the expansion in cross-border operations has been largely a consequence of the enhanced communications infrastructure in the region as well as the reduced restrictions on regional travel.

What cross border operations have done is to encourage greater competition in various domestic markets. In Ghana, it is acknowledged that the arrival of Nigerian banks forced down the lending rates of banks significantly while pushing up deposit rates (ISSER 2007). It is obvious that in view of the smallness of the domestic markets, the authorities in various countries might encourage the entrance of other regional banks as a way of reducing concentration in the markets. The regional banks benefit from economies of scale if properly structured.

Another area of considerable interest is what should happen to development finance institutions (DFIs). Despite the fact that DFIs became the whipping horse of market analysts in the 1980s there are still a number of such institutions in operation in many countries. They have not been entirely shut down because governments still find that there are hardly any new institutions that provide the type of finance that these were intended to provide, namely term finance for industrial development, agriculture and for housing at fairly low interest rates. At the same time the pursuit of market-based reforms does not allow governments to use public resources to adequately support them to function as they would like to. Ironically, faced with this situation many of them are moving into universal banking, but with an eye on support from the state, no matter how limited. Governments need to consider what they want to do about development finance. Where development banks are found they hardly operate as development banks.

In the attempt to deal with the challenges of term finance in the face of weak DFIs, there is growing interest in the development of publicly sponsored credit guarantee agencies (Honohan and Beck 2007). Credit guarantee schemes generally involve the securitization of credit by banks and its sale to other banks or non-bank financial institutions. Its attraction is the security provided by the government and the fact that the facility is repackaged in a form that other institutions would like to hold. But in the absence of an active secondary market it is difficult to attract large investments in these securities. It is interesting that these lead to credit derivatives that have been at the bottom of the current global financial crisis. While there are clear institutional challenges to the design of derivatives for term finance, they would appear to offer some scope for trading risks across different types of financial institutions. What this calls for is a tighter set of controls that will govern the relationships between banks and the non-bank institutions that they collaborate with.

In the search for term finance, attention is also being focused on other possible sources of such funds. Pension funds and other social security funds may offer considerable resources for long term investment but that depends on their value over time, and which depends on how they are managed. There is some concern that over the years, pension and social security funds have not been properly managed as a result of difficult rules about how they can be invested and the lack of properly organized markets. In the absence of well running securities markets many pension and social security funds have

been confined to the property market where the assets are fairly easy to value, compared to equities in markets with information paucity. What this calls for is governments that will strengthen the securities markets. A well functioning securities market provides opportunities for managers of pension funds to benchmark their investment strategies. Clearly, as insurance companies, for example, begin to look increasingly at life business, the issue of how to make their resources available for term finance will grow. The viability of such an option is enhanced by the presence of a good securities market. The absence of secondary trading in most of the markets is a major challenge to the transformation of assets into forms that can be used for financing long-term productive investments.

Expanding the Tax Base

The study by Le et.al. (2008) confirms earlier suggestions in the available literature that there are limits to how far developing countries can expand the scope for taxation efficiently and equitably. The ability to expand the base depends on the underlying taxable capacity and the country's initial level of tax collection. They suggest that "while taxation is the best reliable alternative to finance public spending in the long run, developing countries generally experience a chronic gap between the level of revenues and the desirable level of public funds. The structural issues related to taxation indicate that all countries have to adopt a long term vision for taxation reforms, and specific strategies for reforms cannot be "one size fits all.""

Le et.al (2008) argue that countries with a low level of actual collection and low tax effort may have some scope for raising revenues to reach their potential without any worsening of economic distortions in the medium term. On the other hand, low-income countries, who find themselves in the situation of relatively low collection and high tax effort have less scope in the short term to enhance revenue without inducing high collection (both compliance and administration) costs and creating negative incentives for the formal sector.

Le et.al (2008) also note that in addition to structural factors, the politics of taxation is crucial in revenue reforms in all countries at vastly different levels of development. In this regard, Lora et al. (2006) as well as Fjeldstad and Rakner (2003) have made the point that taxation is highly path-dependent due to resistance from elite groups. In addition, "the wide-reaching effects of taxation as well as the common pool nature of tax revenues make it difficult to reach the cooperative solutions on establishing simple, efficient and equitable tax systems" Le et.al (2008). What all of this means is that the political challenges to tax reform are huge. It is for this reason that in several countries there are hardly any public discussions of tax reform and what new taxes may be introduced. In many countries property taxes are very low and paid by a very few people, while land taxes are never discussed. It is important that African countries open up the discussion of all tax reforms in order to achieve considerable buy-in from the people who will eventually pay any new taxes. Considering that tax reforms must be country specific, they must rely on comprehensive analysis of the country's revenue potential, revenue performance, and political readiness in order to institute difficult reform measures.

In the study by Le et.al. (2008) they suggest for the group of countries with low tax collection and low effort, "an improvement in tax collection would require that these low and lower-

middle-income countries undertake comprehensive reforms of both tax policy and tax administration". They argue that "revenue enhancement should be one of the key objectives for the reforms as long as it is compatible with efficiency and equity criteria". In doing this they need to pursue tax policies that broaden the base, rationalize the rate structure and provide incentive schemes. They must remove tax-induced economic distortions with focus on enhancing revenue productivity of major taxes, particularly the broad-based consumption VAT.

For the countries that have been classified as having low collection but high effort, Le et.al (2008) recommend that "Short-term tax reform measures should aim at streamlining tax policy and tax administration procedures to reduce compliance costs and encourage formality, and to lower tax barriers to firms' entry and operations". They suggest that medium to long term reform priorities should aim to expand the scope for raising revenue by broadening the effective tax base and enhancing the functioning of the tax administration.

6. SUMMARY AND CONCLUSIONS

This paper has indicated that the global financial and now economic crisis is affecting African economies in a significant way, albeit mostly indirectly through the harm they cause to the real sectors of the economies as a result of their engagement with other more affected economies. While the availability of external resources for productive ventures will definitely suffer significantly over time, the availability of domestic resources will be constrained largely by the same factors that have always inhibited their availability and use for development purposes. Thus, for example, while tax revenue is not likely to reduce significantly even if trade taxes went down as has been seen in some countries, the tax revenue is still limited for most countries and the problems associated with this are largely institutional and structural. The same applies to domestic financial resources whose availability over the years has been constrained by institutional and structural constraints. But it is these limited resources that are guaranteed to be available to African economies at this time of crisis.

The paper has summarized the known options for enhancing the mobilization of domestic resources, focusing on how to strengthen financial institutions and what options there are for reforming tax systems. The options place emphasis on the institutional and structural problems that must be tackled.

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