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Mobilising Domestic Financial Resources for Development

From its agenda, it is apparent that as much attention will be focused at UNCFD on: (a) what governments of developing countries need to do to increase domestic resource mobilisation (for financing their own development) as on (b) what governments of developed (donor) countries might do to provide greater amounts of external and particularly official concessional financing (ODA) from their budgets. If more rapid development and growth is to occur, it is unarguable that the bulk of the additional resources required will need to be generated locally in developing countries themselves.

3.1 Findings and Recommendations of the Zedillo Panel Report

In dealing with this issue, the Zedillo Panel Report articulates many obvious, uncontestable views on the importance of domestic resource mobilisation in financing development and the responsibility that developing country governments have in maximising the availability of such resources. It highlights the importance of:

- Good governance, property rights and the rule of law;
- Sound domestic macroeconomic policies consistent with sustained growth;
- Fiscal discipline, tax reform and sufficient revenue to finance an acceptable level of social public expenditure sufficient to meet IDG-2015 targets;
- Institutional infrastructure and appropriate standards (for labour safety, the environment, etc.), for regulating and supporting productive market behaviour, rather than encouraging market failure;
- A financial system that intermediates domestic resources efficiently and effectively.

In contrast to ZPR's selective approach, SGR makes 23 broad suggestions in this area, some of which focus on enhancing tax revenues through revision and greater progressiveness of tax systems, coupled with more aggressive collection efforts. If followed, some of these suggestions risk reversing the progress that has been made over the last two decades because they would slow down growth and discourage greater private sector participation. Of the ideas expressed by SGR, the only specific recommendation that ZPR takes up to enhance domestic savings is compulsory provision of pensions through a two-part scheme:

(a) A fully-vested, defined contribution scheme – requiring compulsory contributions by all individuals – that could be state-run, or privately run and regulated by the state, with mandatory individual contributions as a proportion of income; together with

(b) A tax-financed scheme with a progressive redistributional impact to ensure a minimum pension for all.

ZPR qualifies its recommendation with the caveat that the importance of each element (i.e. contributions v. tax) is likely to vary by country, depending on the solvency of the extant pension system and the weight a society places on social cohesion.

In dealing with the complexities of mobilising domestic resources and maximising domestic savings for financing development, SGR's and ZPR's analyses (and their recommendations) are inadequate. A pension scheme of the type proposed might make sense for many middle-income developing countries in enhancing the contribution of involuntary savings to resources available for development investment. But it ignores fiscal and financial realities in low-income countries with large populations, unpropitious demographics, and very large rates of open unemployment and underemployment. With such a recommendation, the devil lies in the detail that applies at the country level. It is not amenable to sweeping generalisation of the type resorted to.

Regrettably, ZPR is silent on domestic resource mobilisation potential that could be realised by reducing and reversing the current misallocation of public resources in most developing countries. These include, *inter alia*, wasteful expenditures on defence and internal security; an unaffordable 'overhead cost' of government in most countries with too many ministries, too many unproductive (or counterproductive) public employees and indulgence in frivolous expenditure on ministerial travel and bloated security entourages; producer and consumer subsidies that do not target the poorest; insufficiently prioritised capital investment; pork-barrel politics, etc. It is surprising that ZPR does not estimate the potential (globally and regionally) for releasing a significant incremental proportion of GDP (varying roughly between 8–15 per cent across the developing world) for essential social expenditures in most developing countries, if existing levels of public dissaving could be curtailed with public expenditures rationalised and re-prioritised to targeted social needs and meeting the International Development Goals for 2015 (IDG-2015).

Nor does ZPR deal adequately with the several extant impediments to galvanising private savings in developing countries; not least the fact that individuals and corporations are unlikely to increase financial savings in currencies that cannot be relied on to maintain their value with the storage of wealth. Both these weaknesses mean that ZPR's analysis and recommendations must be treated with caution. To attempt to redress these weaknesses in ZPR, this paper attempts to extend the analysis illustratively and make recommendations of its own. These are presented below.

3.2 Additional Issues for Commonwealth Finance Ministers

What does financing for development include?
Before delving deeper into the importance of domestic resource mobilisation, a small digression is justified to ask: 'What does "financing for development" imply?' The answer is not immediately or intuitively obvious. ZPR implicitly assumes that FfD is needed to: (a) finance an adequate rate of growth, without illustrating what that growth might need to be; (b) meet IDG-2015 requirements; (c) cope with humanitarian crises; and (d) finance global public goods.

Taking these four 'uses' of FfD as lodestones for quantifying FfD needs (whether for a country, a sub-group like the Commonwealth, a region or the developing world as a whole) leads to a near-impossible task. It is not easy to estimate the total, domestic or external financing needed for 'development' from the traditional data series that are invariably referred to. FfD needs are not captured (entirely or adequately) in the *hard investment* data series (for example, in data on gross or net investment) published by governments and IFIs. Moreover, FfD implies financial requirements that go beyond resources for physical investment. It embraces funding for *consumption support* (for example in connection with poverty-alleviation) and for *soft investment* (for example in human, social and institutional capital) that appear on national government accounts as public expenditure.

In addition, FfD includes requirements for *technical assistance*, *institution and capacity-building*, and knowledge-transfer; *payments for intellectual property rights* (for example in areas such as pharmaceuticals for immunisations, vaccines and drugs needed to combat endemic diseases as well as HIV/AIDS). It covers *exigent resource requirements* and *transition or contingency financing* for rectifying external and internal account imbalances via stabilisation or structural/sector adjustment programmes, as well as other variants of crisis management and post-crisis rehabilitation (such as debt restructuring and reconstruction finance) that may not involve any specifically identifiable investments as such. It also covers, as ZPR acknowledges, *global public goods* and the costs of *humanitarian relief*.

Development assistance (often, but wrongly, regarded as being synonymous with development financing) shown in the ODA data series of OECD covers funding for food aid, humanitarian relief, refugee assistance in the midst of conflict and natural disaster management, for example droughts, floods, earthquakes, tidal waves, mudslides, etc.

These different needs, financed by a variety of sources in an even wider variety of ways, add up to a mixed bag whose contents are difficult to identify specifically or trace easily.[5] There are large reconciliation problems not just with errors and omissions on the balance-of-payment accounts but also between the accounts of donors and recipients on aid flows. These rarely reconcile because payments made for technical experts in donor countries show up on donor accounts as ODA expended but not on recipient country accounts as ODA received, while local expenses for experts (such as housing, transport and subsistence) show up on developing country accounts but not on donor accounts.

For the developing world as a whole, an average of about 95 per cent of resources for financing all aspects of development are domestically mobilised resources.[6] Yet it is the 5 per cent tail that wags the 95 per cent dog when it comes to setting priorities for the global development agenda. A major goal for UNCFD should be to restore a sense of balance and perspective, on the part of both donors and IFIs, by allowing countries that finance 95 per cent of total development investment to have a say proportionate to their financing in determining what their global development priorities and strategies should be, instead of continuing to allow external interlocutors who finance less than 5 per cent of the total to have the overwhelmingly dominant voice.

To put arguments about domestic resource mobilisation and external financing requirements in an understandable context, three tables are presented below for illustrative purposes. Table 4 shows the financial resources expended on *physical* investment as captured in the gross domestic capital formation (GDCF) data for 1999. It indicates that 13 per cent of such resources were externally sourced (some

5 These technical and data difficulties notwithstanding, it may nevertheless be possible to obtain a sense (in order of magnitude terms) of what the FfD needs of the developing world might be, what proportion might reasonably be expected to originate locally and the residual amount that needs to be financed externally. A simple, and much criticised, exercise of this nature was undertaken for UNCTAD-I in 1964 when the trade gap was estimated, starting from the UN Development Decade target for minimum annual growth rate of 5 per cent in the income of the developing countries.

6 This average obscures a wider range of proportions of domestic resources in the total FfD mix (between 60–98 per cent) when a country-specific or regional picture is developed. At present, a regional picture shows that sub-Saharan Africa is most dependent on external financing while East Asia is least. Some individual sub-Saharan African countries are excessively dependent on external resources. In extreme cases in some of the poorest African countries, this is reflected in ratios that indicate external resources (mostly ODA) accounting for over 50 per cent of the annual public budget, over 65 per cent of gross domestic investment and over 50 per cent of the gross current account deficit.

Table 4. Sources of Financing for Investment in Developing Countries 1999
(Amounts in $ billions; figures in parenthesis are as a percentage of GDI)

	All developing countries	Low-income countries	Middle-income countries
A. Gross Domestic Investment	1530	213	1317
B. Total External Flows	261	38	223
C. Investment Related External Flows	201 (13%)	18 (8%)	183 (14.0%)
D. o/w Official Flows	13 (1%)	7 (3%)	6 (0.5%)
E. Private Flows	188 (12%)	11 (5%)	177 (13.5%)
F. o/w FDI	171	11	160

Source: Global Development Finance (1999), World Bank, Washington DC

from other developing countries), while 87 per cent originated from purely domestic sources.

The differences across developing regions are highlighted in Table 5. Several key features become immediately apparent:

- The developing world as a whole (including the transition economies) did not have a resource imbalance; domestic savings were sufficient to cover the investment that took place. But such investment supported an average growth rate of about 3–4 per cent, instead of the 7–8 per cent that needs to be achieved;
- Excluding the transition economies[7] the rest of the developing world would have had a resource imbalance of –3 per cent of its collective GDP;
- Excluding Eastern Europe, the developing world's output is dominated by East Asia and Latin America, with these two regions accounting for nearly 75 per cent of output. There is a combined resource surplus of +4 per cent of GDP for these two regions;
- The South's two poorest regions, South Asia and sub-Saharan Africa, have the largest resource imbalances. They cannot finance their investment from domestic savings. They also have the South's lowest levels of investment and savings.
- If the East Asia/Pacific region is excluded from the picture, the average investment ratio for the South drops to 20 per cent of GDP. The resource imbalance for the rest of the South actually becomes –5.5 per cent of GDP, translating into a shortfall of about $260 billion between actual investment and the domestic savings available. That shortfall was financed largely by external resources, especially by private flows;
- Excluding East Asia, the resource shortfall in the rest of the developing world would be much larger if developing regions were to increase their investment/GDP ratios to the East Asian level (33 per cent of GDP).

Based on what is known about development, and what has been achieved in East Asia (and countries such as Botswana in Africa), a GDI/GDP ratio of 30–33 per cent is necessary for the developing world to increase its GDP

7 The economies of Central Asia are very poor developing economies comparable to the poor countries of South Asia and sub-Saharan Africa in most respects. The so-called transition economies of Eastern Europe are structurally and income-wise in the same position, or worse off than, most of East Asia and Latin America. Hence the distinction between these transition economies and the developing world is artificial. It is based on a legacy notion of the 'second world' that featured as a distinct geo-political entity in the Cold War era. It is a distinction that should now be dropped with these countries being included within the ambit of the more all-embracing term 'developing countries'. That is what they are.

Table 5. Gross Domestic Investment, Savings and Resource Balances in the World 1999[8]
(US dollars are in billions; percentages are % of GDP)

	GDI	GDS	XGS	RSB	GDP	GNP	@PPP
High-income Countries	**21%**	**22%**	**22%**	**+1%**	**$23,663**	**$22,921**	**$21,763**
Developing Countries	**23%**	**23%**	**26%**	**0%**	**$6,558**	**$6,311**	**$17,324**
of which							
Low-income Countries	19%	16%	27%	–3%	$1,068	$988	$4,315
Middle-income Countries	24%	27%	28%	+3%	$5,490	$5,323	$13,022
East Asia and Pacific	33%	38%	39%	+5%	$1,890	$1,833	$6,424
South Asia	21%	17%	12%	–4%	$596	$581	$2,695
Europe and Central Asia	20%	23%	38%	+3%	$1,094	$1,022	$2,654
Middle East and North Africa	22%	19%	25%	–3%	$590	$599	$1,338
Sub-Sarahan Africa	17%	14%	27%	–3%	$333	$321	$929
Latin America and Caribbean	21%	20%	16%	–1%	$2,055	$1,955	$3,197

Notes: GDI = Gross Domestic Investment; GDS = Gross Domestic Savings; XGS= Exports of Goods/Services; RSB = Resource Balance; GDP = Gross Domestic Product; GNP = Gross National Product; @PPP= Converted at Estimated Purchasing Power Parity Exchange Rates
Source: World Development Indicators, 2000. World Bank, Washington DC and WDR 2000/2001

growth rate to the East Asian level of about 7–8 per cent. Had investment averaged 33 per cent of GDP for the developing world as a whole, the resource gap for hard investment would have been over $630 billion in 1999 (in Table 6 dollar figures for GDI and GDS have been extrapolated from Table 5).

If other FfD needs were added to this figure of financing requirements for hard investment, the total FfD gap would be between $750–800 billion. Clearly, a gap of this size could not be bridged by increasing savings efforts in developing countries themselves at their current levels of per capita income and with their large amount of public sector dissaving; this, of course, must be reduced.

Table 6 illustrates a hypothetical situation. Except for East Asia, the amount of investment as a proportion of GDP in other developing regions is inadequate to generate the sustainable growth rates that developing countries, as a whole, need to aim for. It is unlikely that GDI can be increased to 33 per cent of GDP quickly across the developing world. For that to happen, domestic savings would need to rise to 28 per cent of GDP in the next year or two, and to 30–35 per cent thereafter. That would leave a short-term resource imbalance of 5 per cent of GDP to be financed externally. If savings could be increased throughout the developing world from an average of 23 per cent to 28 per cent of GDP (a proportion that could be realised in most regions other than Africa if public sector dissaving was reduced to zero), then the resource imbalance that would have needed to be financed in 1999 would have been about $330 billion.

If 85–90 per cent of the resources for *hard investment* in developing countries are of domestic origin, and investment has to be lifted from an average of 23 per cent of GDP in the developing world to between 30–33 per cent,

8 Unfortunately the WDI data series reports on 132 economies out of 206 (WDR for 2000/2001). Thus it is incomplete, although it probably captures about 95 per cent of the world's output, population and trade. Figures for this table have been rounded out to add up.

Table 6. Resource Gap in the Developing World in 1999 if GDI were 33 per cent of GDP
(Amounts in US$ billion)

	Actual dollars 1999		GDI/GDP = 33%		
	GDI (A)	GDS (B)	GDI in $ (C)	Resource Imbalances C – A	C – B
High-income Countries	**4,969**	**5,205**	**n.a**	**n.a**	**n.a.**
Developing Countries	**1,530**	**1,540**	**2,164**	**634**	**624**
of which					
Low-income Countries	213	202	352	139	150
Middle-income Countries	1,317	1,338	1,812	495	474
East Asia and Pacific	610	685	612	2	–73
South Asia	122	95	199	77	104
Europe and Central Asia	207	226	363	156	137
Middle East and North Africa	118	102	197	79	95
Sub-Saharan Africa	54	42	112	58	70
Latin America and Caribbean	419	390	681	262	291

Source: Derived from Table 4; based on WDI-2000 and WDR 2000/2001. World Bank, Washington DC

then domestic savings have to increase in response, i.e. from an average of 23 per cent to at least 28 per cent before rising to 30–33 per cent, to avoid incurring too large a resource imbalance, the financing of which from external sources might not be sustainable. Domestic savings in East Asia are already at 36–38 per cent of GDP. Its resource surplus of savings over domestic investment enables East Asia to finance investment in the rest of the developing world, as well as financing resource flows to the developed world. (Korea, for example, invested large amounts in the USA and UK in the 1990s.) But as Table 5 shows, in the rest of the developing world the domestic savings rate varies from 23 per cent in Eastern Europe and Central Asia to a low of 14 per cent in sub-Saharan Africa. These savings rates are far too low, even as a starting point, for achieving the upward boost of investment that is needed to propel growth to an annual rate of 8 per cent or more annually.[9]

Clearly, before asking governments in industrial countries to do more in providing ODA and non-concessional FfD, governments of developing countries need to show resolve and good faith in putting their own houses in order. At UNCFD, developing countries should pledge to adopt strong measures (policy, institutional and implementation) to lift domestic savings rate in their own countries in a steady and sustainable fashion and adopt firm annual targets against which their performance can be measured.

The argument made by African countries, for example, that per capita incomes in their countries are too low to permit higher levels of

9 In its abbreviated compendium of global development indicators, *The Little Green Data Book 2001*, the World Bank shows net domestic savings (i.e. gross savings minus consumption of fixed capital) and 'Genuine Domestic Savings' (defined as net domestic savings + education expenditures, – (energy depletion, mineral depletion, net forest depletion and carbon dioxide damage)). These savings ratios (cf. GDS in Table 4) for developing regions in 1999 were:

	World	EAP	South Asia	ECA	MENA	SSA	LAC
Net Domestic Savings as % of GDP	12.3	27.1	9.5	15.6	15.0	6.0	9.1
Genuine Domestic Savings	15.0	25.0	8.0	11.9	–1.3	3.8	9.7

domestic savings needs to be examined carefully. In most African countries, the salary cost of government machinery amounts to between 8–10 per cent of GDP in the smaller economies; it averages about 5–6 per cent of GDP for sub-Saharan Africa as a whole. That frictional loss imposes too heavy a burden on the fragile GDP of most African countries. It is a disproportionate cost that Africa cannot afford to keep incurring if it is to develop and catch up with the rest of the world.

In South Asia, where per capita income levels are even lower than Africa, and the number (and proportion) of people living in absolute poverty is higher, domestic savings rates are, nevertheless, significantly higher than in Africa. They would be higher still if public sector dissaving could be reduced. In India, for example, private savings are about 27 per cent of GDP, but government dissaving amounts to –4 per cent of GDP, resulting in an overall GDS ratio of 23 per cent. Thus low incomes are not a plausible reason for low savings. By the same token, in Latin America and the Caribbean, where per capita incomes are 7–8 times higher than in South Asia, and three times higher than the average for East Asia (which is heavily affected by the weight of China), the ratio of savings is a desultory 20 per cent of GDP.

To address this inadequacy in mobilising domestic resources for development to the greatest extent possible, developing countries (except those in East Asia that are over the limit) need to take resolute action to increase private savings and reduce public dissaving. Such actions should be taken regardless of what developed countries are prepared to do to enhance FfD. What the developing world is prepared to do should *not* be presented at UNCFD as a bargaining chip. That stance would be self-defeating. Developing countries need to do whatever they can to help themselves before they can legitimately criticise donors for not doing enough. Governments of developing countries should, therefore, resolve to take measures and establish targets that can be monitored by the international community.

3.3. Targets for Increasing Gross and Net Domestic Savings

Governments of developing countries should aim at increasing GDS in their economies by 1 per cent of GDP each year until 2015. This would permit all developing regions except Africa to achieve a GDS ratio of 28 per cent of GDP between 2007–10 and for Africa to achieve that target by 2015. It would also permit developing countries (except in Africa) to reach an investment target of 33 per cent of GDP by 2015 and for Africa to reach that target by 2020. To achieve such targets further public policy measures may need to be taken, for example:

- Reduction of wasteful public expenditures by central, provincial, local and municipal governments. Governments should ensure sustainable, balanced recurrent revenues and expenditures, compatible with provision of a minimum acceptable level of essential government services.
- Balanced recurrent revenue/expenditure accounts by 2015. Development investment (for example infrastructure that cannot be financed by the private sector, such as rural roads and railways) should be financed from domestic bond issues and targeted ODA or official finance.
- Reduced fiscal support for public sector enterprises (PSEs) with a rigorous programme of corporatisation and commercialisation that enables PSEs to be run on independent, professional business lines without political interference. Fiscal support for PSEs should be reduced to zero within five years, i.e. by 2007. PSEs should be required to enhance profitability and contributions to government revenues (taxes and dividend

payments) by 3 per cent per annum in real local currency terms.

- Commitment to privatisation and divestiture where this is justified by social and political conditions and experience (as it would be in most, but not all, developing countries). It is not possible to apply a common template for all situations.[10]

- In most countries it is difficult for governments to avoid political intrusion in PSEs resulting in non-commercial objectives overwhelming commercial objectives. In such countries, governments should commit themselves to a divestiture rate of *at least* 10 per cent each year of their total shareholding in revenue-generating PSEs that are attractive to private investors, i.e. in the infrastructure, industrial and energy sectors, and in agricultural production, marketing and distribution. The target should be to have government holdings in commercial PSEs across the developing world reduced to zero by 2015.

- Disengagement from pre-emption of domestic private household and corporate savings through direct or indirect ownership of the financial, and especially the banking, system. The role of government should be confined to guiding the financial system and capital markets through regulation, supervision and monitoring of financial institutions and markets. It should withdraw from ownership of all financial institutions, i.e. public commercial banks and finance companies, development finance institutions, mortgage and leasing institutions, life and general insurance companies, unit trusts, mutual funds, pension and provident funds, and other types of asset management companies. Withdrawal should occur in an orderly fashion through a divestiture programme designed and carried out in conjunction with the IFIs and regional banks whose funding might be needed. It should be completed by 2010 in all countries other than Africa and by 2015 in Africa. The aim should be to create in every developing country a competitive, vibrant financial system that offers a range of financial services and savings instruments, and is capable of integrating with the emerging global financial system.

- Creation of a policy framework to encourage growth of long-term voluntary and involuntary savings (for example for compulsory contributions to private pension funds) through appropriately structured direct and indirect taxation policies and incentives to stimulate long-term private saving and financial asset accumulation on the part of private corporations and households.

- Encouraging the growth of wide and deep capital markets for debt, equity and derivatives with institutional and instrumentation diversity. In regions where countries may be too small for viable national markets to develop efficiently, taking into account economies of scale, governments should participate in the creation, regulation and development of *regional* capital markets (for example in the sub-regions of Africa).

These measures indicate the actions governments of developing countries could take to demonstrate their resolve to their own public, and to the international community at large, to increase *domestic* savings to the levels needed to generate sufficient domestic resources to finance development in their countries and regions. In addition to these specific actions to stimulate domestic savings, the governments of developing countries would, as ZPR stresses, need to assure stable and secure macroeconomic environments in which the value of

10 It would be strange, for example, to suggest that governments like those of Botswana and Singapore, that have large majority holdings in commercial entities should divest such holdings. These governments require standards of performance from their PSEs that private companies anywhere would find hard to match. But governments such as these are the exception rather than the rule.

currency would remain sound. They would also need to have stable, rule-of-law-based, representative, socio-political regimes that accorded popular legitimacy to governments and their actions, and permitted the removal and election of governments through non-violent means.