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Enhancing Domestic Resource Mobilization

The first of the six chapters of the 2002 Monterrey Consensus on Financing for Development is on domestic resource mobilization (DRM). This brief reviews the reasons for the importance of DRM and argues that for a number of reasons, DRM should receive much greater emphasis in current development strategies and at the 2008 Doha Review Conference on Financing for Development.

After defining DRM, the brief surveys the reasons for its fundamental importance for growth and development, examines the tradeoffs between domestic and external resource mobilization, considers the implications of the latest international financial crisis, and concludes with some observations on next steps to enhance DRM.

What is DRM?

Domestic resource mobilization refers to the generation of savings from domestic resources and their allocation to socially productive investments. In the broadest sense DRM encompasses the mobilization of human as well as financial resources for investment.

Both the public and the private sector have important roles. The public sector mobilizes domestic resources through taxation and public revenue generation for investment in social services and infrastructure. The private sector mobilizes the savings of households and firms through financial intermediaries, which allocate these resources to investment in productive activities.

Thus, enhancing DRM in poor countries involves deepening the fiscal capacity of the state and improving the social rate of return to public investments. It must also involve deepening financial markets so that they are able to attract a growing proportion of domestic savings and allocate them to commercially productive uses.

Why is DRM particularly important?

In low-income countries confronting widespread poverty, mobilizing domestic resources is particularly challenging, which has led developing countries to rely on foreign aid, foreign direct investment, export earnings and other external resources. Nevertheless, there are compelling reasons to give much more emphasis to DRM.

The most fundamental reason for doing so is that greater reliance on DRM is vital to elevating economic growth, accelerating poverty reduction and underpinning sustained development. High-growth economies typically save 20-30 per cent or more of their income in order to finance public and private investment[1].

In addition, DRM is potentially more congruent with domestic ownership than external resources. Foreign aid invariably carries restrictions and conditionality. FDI is primarily oriented to the commercial objectives of the investor, not the principal development priorities of the host country.

Second, DRM is more predictable and less volatile than aid, export earnings, or FDI[2].

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[1] See the report of the Commission on Growth and Development (2008:3), which concluded that "In principle, countries could rely more on foreign capital to finance their investment needs. But capital inflows over the past several decades have a mixed record. Our view is that foreign saving is an imperfect substitute for domestic saving…to finance the investment a booming economy requires".

[2] See Sunday Khan, "Official Flows, Export Volatility and Domestic Investment in Cameroon", The North-South Institute, Ottawa, 2006. More below on the vagaries of international markets since August 2007.

Third, DRM is critical to "domestic integration"—strengthening economic linkages between domestic sectors (e.g. agricultural – non-agricultural) and regions (e.g. rural – urban) —which is a pre-requisite for successful external integration into the global economy.

Fourth, developing countries contemplating a market-based development strategy confront a problem of "missing markets"; for instance, bond and stock markets or markets for insurance, which either do not exist or are very thin. Public and private-sector DRM must create and populate these markets before external resources (e.g. foreign investors) can play any significant role.

Because of these factors, DRM is critical to the long-term sustainability of development efforts (e.g. achievement of the MDGs, which cannot be financed indefinitely by foreign aid). As a result, DRM is a critical "anchor" for country-led development strategies. Without a substantial effort on DRM, aid, trade and FDI may push developing countries in directions not necessarily consistent with their development priorities. Put differently, financing from these other sources presents countries with opportunity costs and a more difficult balancing act to achieve national objectives.

What are the tradeoffs between DRM and other FfD channels?

There are significant tradeoffs among the various channels of financing for development. If DRM, FDI, trade promotion, aid, etc. were perfectly independent of each other, this would not be at issue. However, they are highly interdependent, with the result that initiatives in one area can impact negatively on other areas. A more coherent approach to mobilizing resources for development would take these tradeoffs into account.

For example, high levels of aid may negatively impact DRM due to budgetary impacts, or indirectly by tying procurement or policy conditionality. High aid levels often skew the government's objectives towards fulfillment of donor priorities as opposed to domestic demands. High and volatile aid also poses significant macroeconomic stabilization challenges (e.g. in Uganda, Tanzania, Mozambique). One consequence has been episodes of very high short-term interest rates, which in turn discourage productive investment in the private sector.

Highly aid-dependent countries, e.g. in sub-Saharan Africa, are also subjected to macroeconomic conditionality, typically imposed by the IMF on behalf of the donor community. Such macroeconomic policies, heavily weighted to achieving consumer price stability by inflation targeting, may result in inordinately high real interest rates that inhibit borrowing and real capital formation.

Another example is debt relief under the HIPC initiative which, at the behest of creditors, explicitly directed beneficiaries to allocate savings from debt relief to social sector investment, rather than to infrastructure and other productive sector investments, which arguably would go further in establishing needed domestic developmental linkages.

Trade liberalization is supposed to accelerate competitiveness and increase export earnings, though it has often resulted in reduced production and export capacities, even in the medium-term, besides reducing government revenues. This is particularly the case in low-income countries that rely heavily on tariffs as a revenue source.[3] In low income countries, only a very small share of revenues lost – due to tariff reduction – have been made up by wider indirect taxation instruments such as the VAT.

There are also potential tradeoffs between DRM 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. Developing countries offering

[3] Sub-Saharan Africa relies heavily on trade taxes – as much as 25% of total tax revenue on average, compared with 18% in South Asia, 10% in Latin America and East Asia, and only 0.8% in high-income OECD countries (data from World Development Indicators, 2006 for countries for which data were available)

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.

Finally, it is important to highlight that enhancing DRM is not simply a question of raising fiscal revenue, or investment and savings rates. Equally important is the issue of how resource mobilization is enhanced and the quality of resources mobilized. In several developing countries (e.g. in Ghana, during the economic restructuring program in the 1980s), revenues were raised with greater regressive taxation (such as VAT) as part of wider restructuring efforts. The net social impact of such efforts may be undesirable, even though the revenue raised is quite impressive. A similar question arises with regard to the utilization of domestically mobilized financial resources, particularly the extent to which these resources are used to finance socially productive and employment-generating investment.

Another international financial crisis

Global financial markets have been disrupted since August 2007 beginning with the subprime mortgage crisis in the United States, subsequently spreading to the banking sector in that country and to Europe as well. The evaporation of liquidity, tightening credit and strong possibility of recession in the OECD countries may impact negatively on the foreign components of the Monterrey Consensus: FDI, trade and aid.

In other words, the international environment has become less conducive to external financing for development. The periodic outbreaks of international financial instability illustrates the fact that in the contemporary global economy, financial crises may be expected at least once every decade (the last being the Asian crisis).

The implication for the Doha agenda is clear: in such periods of international financial instability, and over the long term, relatively greater reliance on DRM can provide even greater ballast for the growth and stability of developing countries than was acknowledged at the time of the Monterrey Conference.

Conclusion

Several points emerge from a brief review of achievements under Chapter 1 of the 2002 Monterrey Consensus.

DRM should be considered particularly critical, compared to FDI, aid, trade and debt relief, for strategic reasons. Much more than other channels of financing, DRM can support integrated, country-led and owned development strategies. The current, deepening international financial crisis also reaffirms the volatility of international sources of financing and the vulnerability of developing countries too dependent on such sources relative to DRM.

Given the strategic importance of DRM, tradeoffs and interrelations with other sources of financing should be recognized and reconciled in a manner consistent with each country's development objectives and priorities and its need to privilege DRM. For example, the speed and scope of tariff reduction (and the consequent possible reduction in tariff revenues) should be tailored to the availability of other sources of public revenue and taxation. Similarly, the promotion of FDI via tax incentives should be compatible with the need of local authorities for corporate tax revenues.

To sum up, unless these weaknesses in the Monterrey Consensus are remedied, domestic resource mobilization will continue to under-perform, undermining growth and development prospects, particularly in the world's poorest countries.

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