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Domestic resource mobilization in poor developing countries

The financial crisis, which originated in the developed countries starting with the United States, has by now engulfed both emerging economies as well as LDCs. While emerging economies are likely to withstand the crisis better and emerge earlier, the outlook for low income countries is less rosy although most developing countries had, in place, what were widely touted as 'responsible' fiscal and monetary policies.

The channel of transmission was not the decline of asset prices and losses in the financial sector, as in the case of transmission to other developed countries. Instead, the crisis has been transmitted through the now familiar 'sudden stop' mechanism where capital inflows to the developing world dry up. The drying of trade credit and the recession-induced reduced demand for developing country exports has helped exacerbate the impact on developing countries.

Too little finance

While many commentators are blaming the crisis on 'too much finance', for developing countries this is equally a crisis of 'too little finance'. Even in poor countries such as Ghana, citizens have been shown to save as much as 30% of their income in poor rural areas. However, the lack of access to financial services for most citizens, especially in the rural areas, means that most of this is locked up in the form of fallow land holdings, cattle, jewellery or cash under the mattress, and hence is unavailable for on-lending to entrepreneurs and businesses which constitute the lifeblood of a dynamic economy. These savings are thus not productively deployed which, in turn, depresses growth and potential tax revenues.

Both private and public sectors, not having access to this pool of savings, are forced to be excessively dependent on external sources of finance in the form of aid, foreign borrowing and private capital flows. This makes countries, especially LDCs, desperate for external cash, and they stand ready to accept aid with all forms of damaging conditionality, build up excessive debt burdens and try attracting foreign investment, even on unfavourable terms. They are also overly dependent on exports of mostly primary commodities and have, in recent years, become more dependent on migrant remittances.

Excessive reliance on external resources at the cost of domestic resource mobilization

This not only shrinks policy space, but also makes them more vulnerable to factors and developments beyond their control, as the financial crisis has so vociferously demonstrated. However, despite the significant potential to mobilize domestic resources in developing countries, most international discussions of development policy seem to focus excessively on external sources of finance. The much talked about financing for development conference of the United Nations, for example, devotes only one section (out of six) to domestic resources.

This can be attributed to two factors: First, given how poor many developing countries especially LDCs are, most development professionals assume that there is little scope for mobilizing significant domestic resources; second, external actors may feel that their role is more relevant in helping mobilize external resources and that domestic resources are the primary responsibility of developing countries themselves. Whatever the reason, domestic resource mobilization gets too little attention, both from LDC governments and from donors. This is likely to change after the financial crisis which, once again, has highlighted the vulnerability that comes from dependence on external sources of financing.

The low income-low savings-low productive investment-low growth trap

LDCs are, by definition, poorer and more vulnerable than other developing countries, and have lower levels of human development. Since the potential for savings increases with incomes, LDCs generally have lower savings. Another important factor that affects savings is the dependency ratio, which again is highly unfavourable in LDCs, especially in Africa. Despite this, the level of aggregate savings in many LDCs is still substantial - 20-30% of GDP.

However, it is clearly not enough, from a development perspective, for these savings to exist. They need to be channelled into productive investments which generate growth, poverty reduction and additional tax revenues to enable public investment. This is the role of the financial system which intermediates resources from savers to investors who are better placed to use them productively. On this front too, LDCs lag behind other developing countries. LDCs are, on average, more rural, with poorer infrastructure and lower human development levels, all of which hamper access to finance and undermine effective intermediation of savings.

So, LDCs are characterized by high development needs, low savings rates as well as inefficient and ineffective financial intermediation to channel these into productive investments. This locks them into a low income – low savings – low productive investment – low growth trap from which it is difficult to escape solely through dependence on volatile and conditional external resources.

Policy action is needed on several fronts to get out of this trap

That is why action is needed on multiple fronts to help LDCs escape this trap. Some development needs, such as provision of basic health and education services which help improve human development, are being partially fulfilled with external support in the form of aid. Others, such as infrastructure development and agriculture, have been largely ignored by external finance, but are critical for the purpose of enhancing domestic resource mobilization and increasing productive investment capacity. Urgent action is needed on these fronts. Savings rates need to be increased, and while government nudges can help, the most promising avenues for action lie in helping increase access to proper savings instruments and helping reduce the dependency ratio by reducing birth rates through education and better access to family planning, and helping reduce the mortality and morbidity associated with HIV/AIDS through preventive measures and better access to medicines.

Urgent need to develop domestic financial systems

The most effective way to improve domestic resource mobilization (more savings and better deployment of these savings into productive investments) would be through development of financial systems. Improvement is needed on three fronts in particular: improving access to financial services, both for potential savers and potential borrowers; expanding the portfolio of savings and investment products available, and improving information systems, which can help reduce the risk and uncertainty of lending and investing, and help make better informed decisions about what the most productive use for financial resources might be.

LDCs have notoriously bad infrastructure, large rural populations and high levels of inequality. All this means that traditional banks, with their high fixed costs, are poorly placed to cater to the majority of the population, and remain concentrated in urban areas with high minimum deposit requirements which puts them out of reach for most. The 1980s' reforms successfully tackle some bad banking practices, but also forced closure of many rural branches, the demise of financial vehicles such as postal banks which previously provided greater access to financial services. These IFI imposed reforms also killed many agricultural co-operatives, which provided credit for farmers. On the other hand, the emergence of microfinance institutions, rotating credit associations and informal and semi-formal financial mechanisms have expanded access to finance somewhat.

Clearly, much more effort is needed to expand access to finance. More development of microfinance and meso-finance institutions, a renewed focus on postal savings banks and the increasing use of technological tools, such as mobile phone and internet banking, are all promising ways forward and complementary to one another. An expanded provision of micro-savings, micro-insurance, venture capital and long term financing would help provide the products best suited for the needs of savers and investors, and would necessitate re-establishment of development banks, rural and agricultural banks and other institutions which fill the gaps in service provision that currently exist.

In the absence of 'relationship banking' and information systems such as credit bureaus, etc, lending - especially to micro and small & medium enterprises- remains very risky, and partly explains why LDC banks mostly invest in government bonds and prefer to only lend to large corporations, mostly MNCs. While social capital and accompanying peer pressure can substitute for lack of information to reduce risk as in the case of micro-credit, it can only go so far. That is why mobile phone banking is so promising as it provides a low cost mechanism for greatly expanding access to financial services (as evidenced by M-Pesa in Kenya), but potentially provides a highly promising mechanism to collect transaction data which can then be compiled into a user-friendly database for credit evaluation. This is one very promising way to expand domestic resource mobilization.

Tackling capital flight

Another very promising way of expanding the domestic resource mobilization envelope is by tackling capital flight – the mostly unrecorded and untaxed leakage of resources from developing countries, often into tax havens. The source of this wealth is usually the urban rich, and the larger foreign and domestic enterprises that transfer money by misreporting trade and financial transfers abroad. As much as 5-10% of GDP leaks out annually in this way, and the magnitude of these leakages is often greatest for resource rich LDCs.

Capital flight means that fewer resources are available for domestic intermediation into productive investment. As much of this is also untaxed, it also depresses tax revenues which are extremely low for LDCs –of the order of 10-20% of GDP. Tackling tax flight can thus simultaneously increase both private and public domestic resource mobilization.

More developed domestic financial systems help increase the attractiveness of keeping money in the country and help reduce capital flight. The greater availability of accessible domestic savings can, in turn, help stimulate the development of more effective and efficient banking systems and domestic bond and stock markets.

Thus, national and international efforts to develop financial systems in LDCs and reduce capital flight from LDCs are the most promising avenues for actions to increase the availability of domestic resources and their effective utilization to engender sustainable development.

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