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"Enhancing Access to and Absorption of Development Resources in Africa"

ACBF BOARD OF GOVERNORS ISSUES PAPER

Accessing Funds for Development: Required Capacities for Resource Mobilization and Absorption

This Issues Paper draws on preliminary findings of an Occasional Paper being developed by the African Capacity Building Foundation (ACBF) on this topic.

SUMMARY

African countries are now implementing the Agenda 2063 and Agenda 2030 (also known as Sustainable Development Goals – SDGs), both requiring huge financial resources. Globally, large amounts of investable resources, mostly private, are available in advanced and emerging economies while domestic public resources, even in low-income countries, can be increased when the relevant capacities are in place.

To efficiently mobilize the available resources, therefore, countries need to tackle the binding capacity constraints. These include human and institutional capacity to effectively manage tax exemptions, tax evasion, capital flight, illicit financial flows; constraints to accessing private resources particularly blended finance offered by public private partnership (PPP) avenues; and constraints relating to underdeveloped capital markets in most Africa countries.

Beyond the mobilization of resources, limited absorptive capacity for eternally generated resources in particular, has been recognized as affecting the implementation and effectiveness of various projects and programs on the continent. Though its acuteness differs across countries and sub-regions, absorptive capacity remains a persistent challenge which needs to be urgently addressed. This includes public sector human resource capacity; institutional-level capacity around oversight, governance, and legal systems; and project implementation capacity.

This Issues Paper, therefore, considers the capacity dimensions related to the mobilization and absorption of funds by responding to the following questions **(1) What are the domestic and external resources available for Africa's development? (2) How can the resources be effectively mobilized? (3) What are some of the good practices employed by countries to ensure that the available resources are effectively utilized and fully absorbed? (4) What have been the capacities required to effectively access and absorb the mobilized resources?**

Most recent estimates (2014) show that potential financial resources identified for Africa include more than US$520 billion annually from domestic taxes, more than US$168 billion annually from minerals and mineral fuels, more than US$400 billion in international reserves in respective Central/Reserve Banks of African countries, more than US$1.2 trillion from stock market capitalization, and around US$160 billion from Sovereign Wealth Funds. Additional resources could also be raised through the African diaspora remittances (US$64 billion), diaspora bonds (US$20 billion), and curtailing of illicit financial flows (US$ 60 billion).

Drawing from the case studies of Rwanda and Botswana, the resources can be effectively mobilized if countries invest in technological and human capacity of revenue authorities as part of a broader fiscal reform agenda; strengthen the human and institutional capacities to deal with IFFs; and develop the skills and capacities for the financial markets to mobilize resources nationally and internationally.

Key recommendations on the best ways and practices to ensure that available resources are efficiently and fully absorbed include: (1) building public sector human capacity – public sector needs in-house expertise to interact with the markets, and with private sector entities interested in financing development projects; (2) strengthening the capacity of institutions, legal systems and governance – protection of property rights, protection against fraud and anti-competitive behavior, mitigation of risk and management of social conflicts; rule of law and corruption; and (3) enhancing the capacity for implementation – having effective project management units comprising of multidisciplinary officers across all Ministries, Departments, and Agencies to improve absorption in donor-funded projects.

ISSUES FOR CONSIDERATION/DISCUSSION

- What are the key challenges in accessing funds for development in Africa? Are the main issues related to restrictions on the supply side or the lack of preparedness or capacity on the demand side?
- What are the key factors considered as bottlenecks for the effective absorption of development resources in Africa?
- What has been the particular experience of African countries when it comes to the effective absorption of development resources? What have been the major capacity issues compromising the effective absorption of development resources?
- What are some of the practical solutions proposed based on the case of specific countries or any other experience to show that there are means of tackling the access or absorption capacity issues?
- What are the key actionable policy recommendations proposed for African countries to successfully absorb the available development resources?
- What are the immediate actions to be undertaken to strengthen the capacities of countries and support capacity building institutions to ensure successful absorption of the resources for development?
- How should partners and stakeholders support efforts by ACBF aimed at coordinating capacity development around resource mobilization and absorption on the continent?

CONTENTS

Summary **3**

Issues for consideration/discussion **4**

List of Abbreviations **6**

1. Introduction 7

2. What are the resources available for Africa's development? 8

2.1. Domestic financial resources 8

2.2. Alternative sources of sustainable development financing in Africa 10

3. What are the absorption capacity challenges facing African countries? 13

4. What can we learn from countries managing to absorb resources? 14

4.1. Rwanda 14

4.1.1. Tax reforms 15

4.1.2. Performance on domestic revenue collection 15

4.1.3. Absorption of development finance: Post-2004 Rwanda 15

4.2. Botswana 16

4.2.1. Mobilization of domestic resources 16

4.2.2. Utilization and absorption of resources 16

5. Conclusions 17

5.1. What are the key lessons with regard to access and absorption of resources? 17

5.1.1. Lessons from Rwanda 17

5.1.2. Lessons from Botswana 17

5.2. What are some of the key recommendations on the capacities required for mobilizing resources? 18

5.3. What are some of the key recommendations on the capacities required for absorbing resources in Africa? 18

References **19**

LIST OF ABBREVIATIONS

AAAA	Addis Ababa Action Agenda
ACBF	The African Capacity Building Foundation
AfDB	African Development Bank
AU	African Union
BURS	Botswana Unified Revenue Service
COMESA	Common Market for Eastern and Southern Africa
DFIs	Development Finance Institutions
DRM	Domestic resource mobilization
EAC	East Africa Community
ECA	United Nations Economic Commission for Africa
ECOWAS	Economic Community of West African States
FDI	Foreign direct investment
GDP	Gross Domestic Product
GNI	Gross National Income
ICT	Information Communication Technology
IFFs	Illicit financial flows
IFM	Integrated Financial Management
HIV	Human Immunodeficiency Virus
IDEV	Independent Development Evaluation unit of the African Development Bank
IMF	International Monetary Fund
KCDF	Kenya Community Development Foundation
KES	Kenyan shilling
MDGs	Millennium Development Goals
NEPAD	New Partnership for Africa's Development
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PEAP	Poverty Eradication Action Plan
PPPs	Public-Private Partnerships
RRA	Rwanda Revenue Authority
SADC	Southern African Development Community
USD	United States dollar
VAT	Value Added Tax
ZAR	South African rand

1. INTRODUCTION

The role of resource mobilization, utilization and absorption in achieving development goals as a critical element in the successful execution of development initiatives has been recently emphasized: Agenda 2063 and the post-2015 global development agenda highlight the necessity for African countries to tap into their domestic resources, in particular, in order to finance their development goals. Various accounts suggest that domestic resources can be increased in low-income countries by extenuating leakages. For instance, it is estimated that five African countries (Ghana, Kenya, Mozambique, Tanzania and Uganda) collectively lost USD 15 billion in tax revenues during 2002-2011 due to trade mispricing, which could boost development efforts. One of the recent Africa Capacity Reports by the African Capacity Building Foundation(ACBF, 2015) recommends that countries should tackle the binding capacity constraints to achieve effective domestic resource mobilization. The report identifies many challenges such as low disposable incomes, tax policy weaknesses, legal system inadequacies, low support of the population in addressing governance and development problems, underdeveloped capital markets that lead to precautionary savings being held in nonfinancial forms, poor access to financial markets, and constraints to private-sector resource mobilization. Additionally, resources are available globally and many instruments are at the disposal of African countries to bring in additional funding for development. These include external debt markets, official development assistance, development banks, corporate philanthropic Foundations, foreign direct investment, blended and trade finance, and other innovative funding options. Yet, not all available financial resources have been efficiently mobilized, allocated and utilized to support Africa's development goals.

An equally important issue affecting execution of development projects and programs in Africa, however, is limited absorptive capacity (ACBF, 2016). To illustrate, in some countries, only 20% of the allocated funding for the African Development Bank (AfDB)-funded projects would, until recently, be disbursed (AfDB, 2013a); in other countries, programs supported by AfDB have taken nearly twice as long as planned (AfDB, 2013b). To improve absorptive capacity, countries need to address several key challenges including administrative constraints arising from inadequate infrastructure and equipment; perverse incentives in public officials' performance; post-conflict and post-emergency constraints; inadequate public financial management systems; and uncoordinated and un-harmonized donor interventions.

The challenges of resource mobilization, allocation and absorption, and possible ways of addressing them, have been discussed, in various reports, development agencies and researchers (e.g. ACBF, 2015; AfDB, 2013a). This discussion paper collates these views in order to have a clear understanding of the constraints and set the foundation for developing a framework for capacity enhancement interventions in these areas.

The Issues paper addresses four interrelated questions. **(1) What are the domestic and external resources available for Africa's development? (2) How can the resources be effectively mobilized? (3) What are some of the good practices employed by countries to ensure that the available resources are effectively utilized and fully absorbed? (4) What have been the capacities required to effectively access and absorb the mobilized resources?**

To address these questions, this Issues paper reviews the *relevant existing policy documents and academic literature* from different sources in order to understand the state of financial resource mobilization, allocation and absorption in Africa. The review helps to identify key capacity constraints facing African countries. Evidence-based recommendations identified from the review provide information for identifying capacity needs. Secondly, the Issues paper highlights good practices in these areas from a number of Africa countries. It then specifically singles out *two case studies* of well-performing countries in Africa: Botswana and Rwanda to provide additional evidence on best practices and capacity imperatives for financial resource mobilization, utilization and absorption. Lessons from these countries are used to draw inferences for policy and practice.

The paper is hence structured to consider the issues by: **First, looking at the resources available for Africa's development (both domestic and external), then reflecting on the absorption challenge facing African countries, after which it highlighting the capacities required to access and absorb the mobilized resources largely learning from countries that have succeeded in this area, before concluding with lessons learnt and recommendations for African Governments.**

2. WHAT ARE THE RESOURCES AVAILABLE FOR AFRICA'S DEVELOPMENT?

2.1. Domestic financial resources

Domestic resource mobilization (DRM) can provide countries with the flexibility to devote sufficient resources to fight poverty, bridge infrastructure gaps, provide public services, foster social contract between the governed and the government; strengthen democratic engagement and institutions; and facilitate the virtuous cycle of transparency, accountability and efficiency (ACBF, 2015). There are several possible domestic resource avenues, the sustainable exploitation of which could facilitate Africa's development, as presented in Box 1.

Box 1: Value of potential domestic finance sources – Africa

Source	Value	Source	Value
Tax revenues	US$520 billion p.a.	Stock market capitalization	US$1.2 trillion
Mineral earnings	US$168 billion p.a.	Private equity market	US$30 billion
International reserves	US$400 billion	Bank reserves	US$60 billion
Diaspora remittances	US$40 billion p.a.	Savings in remittance costs	US$2.884 billion p.a.
Remittances securitization	US$5 – 10 billion	Curbing of illicit financial flows	US$854 billion

Source: NEPAD/ECA (2014)

In appreciating the avenues for mobilizing the domestic resources, this Issues Paper first reflects on the challenges that must be addressed in this area. It specifically looks at a number of areas that are considered critical in domestic resource mobilization which include enhancing tax revenues, improving public expenditure efficiency, tapping on domestic financial markets, curbing capital flight and illicit financial flows, and tapping on domestic private sector resources. The section supplements the issues by considering good practices in such areas by some of the African countries.

1. **Enhancing tax revenues.** The Addis Ababa Action Agenda (AAAA) urged governments to commit to enhancing revenue collection through modernized, progressive tax systems, improved tax policy and more efficient tax collection. Whilst improved tax collection in Africa over the last few decades has been documented – see Box 2 for the case of Botswana –, concerns have been raised regarding the following challenges bedeviling tax administration:
   i. Undeveloped domestic tax policies and complex tax administration systems have increased the compliance burden and unwittingly abetted tax evasion and illicit financial flows;
   ii. Difficulty in taxing the informal economy has hampered efforts to broaden the tax base and push for direct tax collection;
   iii. Inadequate human resource capacity and underdeveloped information and communication technology have constrained policy options and impeded revenue collection;
   iv. The complexity of taxing multinational corporations especially those in the resources sectors has also been a major revenue collection bottleneck; and
   v. Preferential tax treatments to various taxpayer groups, through targeted tax deductions, credits, and exemptions, have resulted in significant revenue losses.
   vi. Other commonly cited revenue loss channels are: corruption, transfer pricing by Multinational Corporations, an imbalanced mix of taxes, falling revenues from trade taxes and ineffective urban property taxes.

Box 2: Tapping into tax revenues in Botswana

Botswana raises substantial tax revenues. The tax-to-GDP ratio has averaged about 36% over the years, which is considerably higher than that of neighboring countries such as South Africa (24% to 27%) and Mauritius (18%). Diamond revenues account for much of the total tax revenue; therefore, the public budget and investment spending is also highly dependent on the mining sector. Botswana is one of 18 African countries that have a Natural Resource Fund - the "Pula Fund", originally established in 1993 under the Bank of Botswana Act (1975). The Fund holds savings from accumulated fiscal surpluses and inflows of additional government debt. It has mainly served as a revenue stabilization fund and a holding ground for subsequent domestic investments when productive opportunities for such investments are identified.

2. **Improving public expenditure efficiency.** African governments must institute policies that promote fiscal discipline (responsible spending of tax revenues) to avoid excessive accumulation of public debt and to ensure public-sector borrowing does not crowd-out the private sector from domestic financial markets – see Box 3 for the case of Cameroon. Similarly, public resources should target social spending to promote access to health, education, nutrition and other social programs especially in rural areas where majority of the poor people live. Governments should also strive to provide adequate funding to potentially high-return public goods investments related to technology generation and adoption, strengthen markets, and rural infrastructure which have, hitherto, been largely underfunded and prioritize spending on implementation of smart subsidies, research and development, market access and land governance. The bottom line being to ensure spending in socially and economically productive sectors that would in turn provide for more efficient and sustainable resource mobilization for Government operations.

Box 3: Improving public expenditure efficiency in Cameroon

Cameroonian public asset portfolio performance has improved with a score that rose from 1.8 in 2007 to 2.4 in 2014. Strict application of guidelines on the cancellation of undrawn balances and completion of agricultural and social projects has resulted in the removal of ageing projects. The average project age, which was 5.4 years in 2007, fell to 3 years at end-2012 and 3.2 at end-2013. As at end of 2013, the cumulative disbursement rate for the entire portfolio was 38% and the annual disbursement rate stood at 9.24%; at-end-2014, the cumulative rate had risen to 50.35% and the annual rate to 16.24%. This satisfactory portfolio performance could be further enhanced by strengthening the capacities of some implementation units which have sometimes been a set-back to implementation of projects.

Source: IDEV/AfDB (2015)

3. **Tapping on domestic financial markets.** Government policy could significantly influence national saving either by directly increasing public saving or implementing policies that increase private saving – see Box 4 for the case of Kenya. These include revenue policy (tax structure, tax incentives), expenditure policy (transfers, income redistribution), and the degree of government saving. Governments can also influence savings through reforms in the financial sector. In short, governments can, through various targeted policies, encourage domestic savings and capital formation, which the economy can draw from to support development agenda.

Box 4: Financial markets in Kenya

Kenyan financial services sector is one of the leading in Africa in terms of volumes and diversity of financial instruments and services. Kenya has recorded impressive penetration of banking services with commercial banks branch networks doubling from 512 in 2003 to 1,197 in 2012. This has increased credit facilities to large national and regional projects and small borrowers who were previously unable to access credit facilities and banking services. Further, as a result of various innovations, micro-accounts increased by more than 800% from 1.6 million in 2003 to 16 million in 2012; commercial banks credit rose from KES 447.7 billion to KES 8,888.5 billion between 2006 and 2010. A key component of Kenya's domestic resource mobilization is the state-run Kenya Post Office Savings Bank, established in 1910 to facilitate and streamline private savings by providing tax-exempt interest income to savers.

Source: NEPAD/ECA (2014)

4. **Curbing capital flight and illicit financial flows.** Africa's negative saving-investment gap has been growing over the decades since independence necessitating increasing reliance on external financing. The increased reliance on external debt has coincided with or exacerbated capital flight, which has made Sub-Saharan Africa a net creditor and a de facto leader in the developing world in the share of private wealth held abroad. Studies suggest that repatriation of flight capital would preserve Africa's financial independence and stability, avoid mortgaging the welfare of its future generations through external borrowing, and decently improve domestic investment. However, curbing capital flight and illicit financial flows remains a challenge on the continent due to capacity challenges – see Box 5 for the case of Kenya. To put this in context, only one country (South Africa) has a relatively effective Transfer Pricing Unit to handle such issues (ACBF, 2015).

Box 5: Illicit financial flows of Africa: the case of Kenya

Coupled with its recent development of an extractive industry, Kenya has in recent years maintained steady economic growth with a current GDP of USD 79.66 billion, GDP per capita of USD 1,796, and an average GDP growth rate of 4.8 per cent a year. Kenya is believed to have lost as much as USD 1.51 billion between 2002 and 2011 to trade misinvoicing. The role of IFFs and their adverse effect on the country's GDP cannot be ignored. A recent study funded by the Danish government on five of its priority countries (Ghana, Kenya, Mozambique, Tanzania and Uganda) shows that Kenya's tax loss from trade misinvoicing by multinational corporations and other parties could be as high as 8.3% of government revenue, hampering economic growth and resulting in losses in tax revenue.

To address the illicit financial flows, Kenya has established agencies and passed a number of laws such as: (1) Director of Public Prosecutions; (2) Financial Intelligence Authority; (3) Anti-Money Laundering Act; (4) Financial Institutions Regulations; (5) Anti-Corruption Act; and (6) Anti-Terrorist Act. However, the illicit financial flows are still problematic, in part because of weak regulatory and law-enforcement capacity.

Source: AU/ECA (2014)

5. **Tapping on domestic private sector resources**. The private sector in many countries includes economic agents in small and micro businesses (smallholder farmers, small-scale traders, and artisans), medium size businesses (commodity brokers, and wholesalers) and large-scale agents (commercial and investment banks, manufacturers, large retail outlets). Tapping into private sector resources requires deliberate policies designed to improve the business enabling environment: a good public investment program, developing financial markets, and improving financial inclusion. Box 6 presents the case of Rwanda, highlighting how reforms have helped to foster private sector contribution.

Box 6: Fostering private sector involvement in Rwanda

Rwanda has implemented a number of market-based reforms to strengthen the role of the private sector in national development. Several important laws have been revised, including company law, secure transactions law, labor law, and insolvency law. The new insolvency law facilitates access to finance, allowing movable assets such as livestock to be used as guarantee. Rwanda has also simplified customs procedures, introduced a one-stop window to register businesses and lowered the administrative cost of registering businesses: it is now possible to register a business in one day at a cost of RF 25,000 (USD 43). Rwanda's success in these efforts is reflected in her notable performance in Doing Business indicators, being ranked second in Africa in 2016.

Source: Nielsen & Spenceley (2011)

2.2. Alternative sources of sustainable development financing in Africa

As pointed out earlier, in supplement to domestic resource mobilization, there are other sources of financing that are available globally as well as many instruments that are at the disposal of African countries to bring in additional funding for development. These sources include debt markets, official development assistance, development banks, corporate philanthropic Foundations, foreign direct investment, blended and trade finance, and other innovative funding options.

1. **Debt markets.** In addition to internal borrowings from the domestic debt markets (say, through Treasury bonds), African countries have also the option to borrow externally on international bond markets. However, it is important that the debt be managed carefully to ensure that commitments can be honored under different future scenarios presented by the country's economic growth, exchange rates, and international and national and interest rate changes – see Box 7 for the experience of South Africa. It is recommended to governments to make regular use of analytical tools to assess alternative borrowing strategies and their associated risks and better manage their assets and liabilities (e.g., currency risk can be avoided by issuing securities in domestic debt markets). Such debt sustainability assessments will prevent African countries from plunging back into the debt crisis that had most of them asking for debt relief under the multilateral and bilateral Highly Indebted Poor Countries Initiative.

Box 7: Financing budget deficits through the domestic bond market: The South African case
South Africa's gross borrowing requirement is projected to increase from ZAR 220.9 billion in 2017/18 to ZAR 284.4 billion in 2019/20. Most of this requirement will be met by domestic long-term bond issuance, which will increase to ZAR 197 billion in 2019/20. Domestic short-term borrowing will make up about 12% of government's net debt stock of which ZAR 21 billion will be from Treasury bills. Longer-dated, rand-denominated debt accounts for about 78 per cent of government debt stock: in the 10 months to 31 January 2017, government raised ZAR 141.5 billion by issuing domestic long-term debt comprising of ZAR 110.8 billion in fixed-rate bonds, ZAR 27.2 billion in inflation-linked bonds and R3.5 billion in retail savings bonds.
Source: South African Treasury: 2017 Budget Review

2. **Development Banks.** Apart from the African Development Bank, most African sub-regions also have dedicated development banks that commonly finance infrastructure and innovation, and small and medium-sized enterprises. Being situated within the region of interest, they can leverage their relatively better knowledge of the regional markets to provide capacity development and to assist individual firms with project management. Moreover, international multilateral development banks (such as the World Bank, the International Monetary Fund, the Islamic Development Bank, etc.) have long term investments and resources available for Africa's development.

3. **Foreign direct investment (FDI).** Equity markets are an important avenue through which cross-border financing can be channeled to support countries' development agenda. FDI flows into Africa have been growing with the number of FDI projects increasing by 6% to 705 in 2015, accounting for about 4% of the global total; however, actual FDI capital invested declined by 24% to USD 66.5 billion over the same period. FDI flows, if well managed, can both attract capital, enable technology and skills transfers, and aid domestic capital markets development. Further, policies designed to promote FDI inflows frequently also serve to stimulate domestic private investment and savings within developing countries.

4. **Official development assistance (ODA).** ODA is secured through loans from supra-nationals, government-to-government agreements, and voluntary inter-governmental arrangements amongst groups of nations such as South-South cooperation. Such funding is often channeled towards public assets provision, support of macroeconomic stability, poverty eradication or humanitarian aid. Recent OECD data show that ODA to low-income countries has increased, totaling USD 131.6 billion in 2015, in real terms (correcting for inflation and currency depreciation), a change of 6.9% from 2014. The commitment by richer countries, under the Istanbul Programme of Action, to allocate 0.15-0.20% of their GNI was exceeded as ODA to least developed countries topped above 0.32% of their GNI.

5. **Blended finance mostly Public-Private Partnerships (PPPs).** Instruments commonly used by development finance institutions (DFIs) to leverage private finance such as loans, equity investments, and guarantees and are combined with traditional public private partnerships to create structured public-private funds and innovative implementing partnerships. Blended finance may be justified where institutional environment alone is insufficient to unlock the social benefit from a project that is just below the threshold of real commercial viability; yet, it may not be suitable to meet development needs that do not offer economic returns.

6. **Trade finance.** Trade finance can be provided by established institutions operating within Africa such as commercial banks, Afreximbank, African Trade Insurance Corporation, ECOWAS Investment Guarantee Agency, North Africa-linked Inter Arab Investment Guarantee Corporation, African Development Bank and other institutions (through development lines of credit). Development Banks like AfDB and specialized trade financiers such as Afreximbank could be further capitalized to boost their operating capacity.

7. **Other recent innovative funding options**
   A. **African Diaspora resource.** Diaspora funding can be sought by governments through Diaspora bonds, mutual funds and other securitization forms, or direct participation in development projects. See Box 8 for the success of Ethiopia in mobilizing diaspora resources toward the construction of the Grand Renaissance Dam.

Box 8: Tapping into Diaspora resources: the Grand Renaissance Dam project in Ethiopia
The Ethiopian Government issued diaspora bond in 2011 to secure financing for the Grand Renaissance Dam project. The 2011 bond issuance incorporated features aimed at making it more appealing and practical; they included among other: (i) considerable marketing and awareness-raising campaigns by the government to encourage the diaspora to buy it; (ii) bond offering in minimum denominations of USD 50, which many Ethiopians can have access; (iii) transferability of the bond up to three people, and ability to use it as collateral in Ethiopia; and (iv) covering any remittance fees associated with the purchase of these bonds by the Commercial Bank of Ethiopia.

Diaspora contributions around the world amount to US$39 million. The Dam is 60% complete and two of its turbines will begin generating electricity by the end of 2017, adding 750MW of electricity to the national grid.
Source: ACBF (2015)

   B. **Africa50 Infrastructure Fund.** This fund, owned by African governments, African Development Bank and other institutional investors, was established with the mission of mobilizing long-term savings from within and outside Africa and private sector funding of infrastructure development in Africa. The fund is designed to leverage African pension funds, African sovereign wealth funds, African central banks' foreign reserves and other African institutional investors – see Box 9 on how Nigeria has tapped into the Africa50 Fund to develop a solar plant.

Box 9: Nova Scotia Solar Plant, Nigeria
The Nova Scotia Solar plant is a joint development agreement among Scatec Solar, Norfund and Africa50, for development of a 100 MWdc solar power plant in Jigawa state, Nigeria. Total project cost is estimated at USD 150 million, with financial close expected in 2017 and operations in 2018. The Africa50 Fund is a Project development and long-term equity partner (holding a 24% equity interest).
Source: Africa50 Find website (https://www.africa50.com/about-us/projects/)

   C. **Philanthropic finance.** Philanthropic funding can be mobilized through means such as crowd-funding targeting sustainability conscious African institutions, corporate philanthropic Foundations and citizens. Box 10 illustrates the contribution of private sector and corporate Foundations in supporting development in Kenya.

Box 10: Kenya Community Development Foundation (KCDF)
KCDF is a Kenyan development grant-making organization, registered in 1997 to support communities to initiate and drive their development agenda by harnessing and growing their resources. It is financially supported by a number of private sector players and corporate Foundations mostly. The foundation supports sustainable development of communities by working in a number of key sectors across the country including Economic Empowerment and Entrepreneurship; Food Security and Climate Change Adaptation; Education, and Youth and Children and Policy. The foundation has since its inception been able to provide approximately KES 1.8 billion (USD 18 million) to community led projects across Kenya.
Source: KCDF website: http://www.kcdf.or.ke/index.php/about-us/fact-sheet

3. WHAT ARE THE ABSORPTION CAPACITY CHALLENGES FACING AFRICAN COUNTRIES?

Development finance is said to be effective when it helps to set a country on a sustainable growth path. Accomplishing this ideal depends on the recipient country's technical absorptive capacity, which is the ability to use mobilized capital productively. Knowledge of the ability of Africa to effectively allocate and absorb development funds is important given the continent's high levels of poverty amidst high levels of aid flows relative to other regions. Structural constraints facing African countries' absorptive capacity are as follows.

1. **Political, institutional and policy weaknesses.** High (and increasing) levels of aid dependency can provide negative incentives for much needed reforms, and shift government accountability from domestic to international actors. These negatively affect the allocation of development assistance and the efficiency of its utilization. Institutional weaknesses may cause the problem of aid fungibility which is usage of development resources for purposes other than those for which they were initially intended. This fungibility problem can be cause for protracted discussions between the aid recipient Government and the bilateral or multilateral partner giving aid when issues of ineligibility of some costs arise. The result can be low absorption by end of the project period.

2. **Macroeconomic constraints.** Large increases in ODA inflows could provoke a 'Dutch disease' effect, causing appreciation of the exchange rate and reducing competitiveness of the recipient country's exports. Second, development inflows in the form of loans often cause concerns about debt sustainability. Third, since aid inflows are often unpredictable, they can affect macroeconomic stability negatively by triggering inflation, interest-rate and exchange-rate volatility. Finally, aid increases may cause labor market pressure through high demand for skilled labor and high wages. Such macroeconomic instability can lead to prolonged project implementation periods leading to low absorption of resources by end of project life – Box 11 illustrates the dilemma faced by Uganda.

Box 11: Uganda: Macroeconomic, technical, donor-related constraints and resource absorption

There are structural constraints imposed by the macroeconomic framework underpinning the PEAP (poverty eradication action plan). To achieve the Millennium Development Goals (MDGs), Uganda needed to mobilize substantially more additional resources and distribute them more equitably across regions. However, the financial flow 'increases' allowed under the PEAP would only be permissible if public expenditures were 'controlled' carefully to stay within the confines of the pre-defined 'macroeconomic stability'. IMF policy statements, not just in Uganda, have generally been supportive of increased aid but only if it can be effectively absorbed and utilized without endangering macroeconomic stability. Underlying the PEAP, the main thrust has been achieving macroeconomic stability: keeping inflation low, limiting government expenditure and floating the exchange rate. Therefore, the need for additional resources is almost in direct conflict with the so-called 'absorption capacity' of the economy. That is, the PEAP identifies priority areas for poverty reduction but can only make budgetary allocations "within existing and available" resources. Otherwise, macrocosmic instability would lead to prolonged project implementation periods.

3. **Technical and managerial constraints.** These come in several forms including human capital and physical infrastructure. For instance, there are reports highlighting that countries find it difficult to recruit, train and retain qualified professionals. Second, inadequate infrastructure has usually hindered access to goods and services and reduced the efficiency of transformation of public spending into better standards of living. Such capacity constraints affect timely absorption of resources.

4. **Constraints generated by donor behavior.** Recipient African countries often have to deal with several donor organizations, each imposing uncoordinated and burdensome practices through small, dispersed projects. Such fragmentation imposes heavy transaction costs on scarce government capacity, taking resources away from core tasks. Also, lack of certainty and predictability of flows, for which aid is legendary, can impede government's efforts to absorb resources aimed at implementing long-term development plans and programs.

5. **Lack of common priorities and institutional ownership.** In some cases, government agencies have lacked ownership partly due to the absence of implementing sector ministries at conceptualization, feasibility studies and financial agreement negotiations of the project. In such instances, the disbursement problems have arisen due to lack of common prioritization of the projects by the government and donors. Box 12 illustrates the case of COMESA member countries.

Box 12: Aid management in the COMESA region
Several countries in the COMESA region lack clear policies on external aid management. Consequently, disagreements often arise on prioritization of development programs between the recipient government and donors. In such scenarios, projects get approved for funding by financiers without proper consultations with relevant government agencies and taking due consideration of regulatory and policy requirements of recipient government resulting in weak institutional and political leadership which hampers project implementation.
Source: http://cmi.comesa.int/wp-content/uploads/2016/03/Best-practice-for-increasing-Donor-funds-absorption.docx

6. **Accounting and reporting.** The existence of inaccurate or incomplete claims has also hindered further disbursement of project funds. In some cases, ineligible expenditures are incurred by project implementers outside categories of expenditures agreed in the Financing Agreement. Inadequate disclosures of material facts during reporting often lead to audit qualifications, thus hindering funds disbursement and hence timelines of absorption.

4. WHAT CAN WE LEARN FROM COUNTRIES MANAGING TO ABSORB RESOURCES?

We analyze two countries that have recently performed well in Africa in development resource mobilization and absorption – Rwanda and Botswana. World Economic Forum (2017) ranks Rwanda the best in Africa for institutional quality and Botswana the best for macroeconomic environment, both of which are necessary conditions for mobilization and absorption of development finance. The two countries also provide an interesting study because of the way their resource mobilization experiences contrast each other: while Rwanda's development has depended extensively on external resources since the genocide ended, Botswana is more inward-looking and has relied on domestic resources to meet her development needs. In both cases, the kind of capacities that helped them achieve their feat are highlighted including the remaining capacity gaps.

4.1. Rwanda

With a score of 5.56 on a scale of 1 (lowest) to 7 (highest), Rwanda is ranked the best in Africa on Institutions, the first pillar of the Global Competitiveness Index (World Economic Forum, 2017). The post-genocide government committed to rapid economic recovery; with prudent monetary and fiscal policies, liberalization of the economy, and institutional capacity building. The economy rapidly rebounded, growing by about 80% between 1994 and 1998, with sustained high rates of growth being recorded since 2004. In 2008, the Rwandan economy experienced its first double-digit real growth rate in over five years, at 11.6%. Development agencies and the Rwandese government have indicated that substantial and sustained increases in development financing are needed to achieve the ambitious development goals. However, Rwanda's development has depended extensively on external resources since the genocide ended. For instance, at the end of 2012, multilateral creditors held more than 84.0% of all government external debt, with a combined 73.8% held by the International Development Association and Africa Development Bank Group. Recent World Bank data show that Rwanda received net bilateral aid flows from Development Assistance Committee members, totaling USD 567.31 million (current USD) in 2014, amounting to approximately 57% of the national budget. The country has therefore sought to increase her DRM and absorption of externally mobilized resources.

4.1.1. Tax reforms

Greater efforts to improve DRM in Rwanda effectively kicked off in 1997 when Rwanda Revenue Authority (RRA) was established. The key tax reforms instituted since then include:

- Widening of the tax base through the introduction of value added tax (VAT) in 2001;
- Widening of the RRA mandate to include non-tax revenues (2003) and income tax rationalization (2005);
- Introduction of a new income tax law, investment and export promotion legislation and tax code, in 2005 to aligning the tax system to development policy priorities;
- Strengthening the compliance enforcement regime by enacting law number 25 of 2005 to cater for tax audits, appeals and penalties for non-compliance with consumption taxes and tax evasion; and
- Harmonization of Rwanda's tax regime and administration with that of the East Africa Community (EAC) in 2009/10.

Rwanda's social context for decentralization reform provides a degree of vibrancy and innovation that sets it apart from other countries in the region. To ensure coordinated execution of tax policy and minimize distortion of economic activity, Rwandese local governments have some discretion in determining tax rates, but may not create new taxes or define the tax base for local revenue sources.

4.1.2. Performance on domestic revenue collection

Rwanda's total domestic revenue stood at 8.4% of GDP in 1993; fell to 3.6% in 1994 because of genocide, then rose steadily to 14.2% by 2008. Tax growth averaged 0.25% to 0.3% of GDP every year from 1997. Taxes on goods and services have formed the largest proportion of total domestic revenues averaging 48% of the total tax revenue over several years. Ratio of direct taxes to total taxes also grew between 2001 and 2008, peaking at about 37.5%. In turn, the contribution of international trade to total tax revenue sharply declined from 41% in 1995 to about 10% in 2008, explained largely by an initial reduction in import duty rates. Growth in real tax revenue likely emanated from measures to raise compliance by existing taxpayers and gains in tax administration efficiency. From 2001 to 2013, total tax revenues as a share of GDP rose by about half amidst declining import duties.

For greater tax collection efficiency, however, Rwanda must address the following key capacity-related challenges:

1. Tax reforms should be continued to achieve a cost-effective strategy to widen the tax net to capture small and micro enterprises which largely operate in the informal sector; importantly, the reforms should include preparing the informal sector to pay taxes;
2. Further, for greater tax collection efficiency, property and rental income taxes, currently under local governments, should be collected by the Rwanda Revenue Authority on behalf of local governments;
3. The government should develop and maintain capacity for tax policy management by improving the bureaucratic and incentive environment;
4. Build a sustainable management capacity within the Rwanda Revenue Authority especially technical and professional skills and RRA's capacity to develop and retain requisite human resources;
5. Perhaps most importantly, a cap should be placed on existing tax incentives and exceptions. This requires a study to understand the pro and cons.

4.1.3. Absorption of development finance: Post-2004 Rwanda

Rwanda's higher level of economic growth, relative to peers in the East African Community, has been attributed to heavy investment in education, healthcare and curbing population growth largely driven by aid inflows (BTI, 2016) and relatively effective aid administration.

The government uses most of the available financial resources quite efficiently (BTI, 2016). Importantly, Rwanda's economic growth depends largely on, the approximately 10%, foreign aid contribution to the GDP.

To illustrate how strong this dependence is, the country's growth rate slowed in 2013 by almost 3% when main foreign donors temporarily suspended assistance. But the country has been able to attract increased funding lately because of her effective implementation of programs and strategies.

4.2. Botswana

4.2.1. Mobilization of domestic resources

Botswana succeeded at reducing its reliance on foreign aid through efficient aid management and the mobilization of resource rents towards investment projects. Botswana has used more domestic resources in her development projects in the recent years than foreign aid, with the share of natural resource rents in GDP rising from only 0.6% in 2001 to 3.58% in 2014, reaching an all-time high of 11% in 2009, according to World Bank data. However, Botswana's economy has struggled when mine expansion slowed because it remains mineral-driven. As a result, the country is opening up to innovative development funding options.

The Privatization Policy of Botswana came into effect in 2000. Through the 2002/3 Budget Speech, and National Development Plan (2003-2008), the government announced that PPPs would be used extensively as a form of procuring and financing public infrastructure projects. Examples of the projects funded through PPP, or proposed for PPP-model funding, include Debswana (USD 10 million), SADC House, and Ombudsman's Office (value estimate unavailable).

Botswana's financial system has grown rapidly recently. Banks, the pension industry, and the Botswana Stock Exchange have grown steadily due to political and economic stability, savings from diamond exports, and fiscal surpluses. For instance, between 2008 and 2016, pension fund assets grew from 30% to 47% of GDP, facilitating a rapid increase in bank deposits and in stock market capitalization, which almost doubled in this period. In tandem, domestic credit to the private sector has increased steadily from 6.64% of GDP in 1988 to 33.81% in 2015 demonstrating investor appetite for debt instruments.

Tax Administration Bill is almost ready for submission to National Assembly as of August 2017. The bill proposes reforms that would modernize tax procedures and reform tax administration to enable Botswana Unified Revenue Service (BURS) improve efficiency and reduce uncertainty about taxation by concentrating its resources on enforcing tax collection from taxpayer groups that are potentially important sources of revenue. The proposed reforms also aim to improve the capacity of the large taxpayers' unit to leverage the about 70% of the tax revenue that comes from them.

4.2.2. Utilization and absorption of resources

Botswana, unlike Rwanda, has been more inward-looking and has relied on domestic resources to meet her development needs making hence attenuating the challenge of external resource absorption capacity. The country has been able to prudently manage its mineral resource inflows as well as build the requisite human and economic capital critical for utilizing and absorbing its resources in the short to long term.

Prudent management of mineral rent. The government, in an effort to manage potential risk of a sudden collapse in diamond prices, has targeted long-term wealth creation and pursued prudent rent management. To this end, it established several funds in 1972 to offset falling aid and to stabilize mineral rent which increased four-fold within a couple of decades. Botswana has utilized its domestic resources prudently since the discovery of diamonds: reports indicate that the government has typically allocated two-fifths of the revenue to offshore investments; financial reserves reached 125% of GDP by 1998.

Building human and economic capital and nurturing the private sector. The Botswana government has deliberately converted diamond rent into human capital and economic infrastructure, alleviating the backlog from colonial neglect. The government also deployed rent to nurture the private sector by sub-contracting goods and service purchases and mobilized private foreign investment to boost its own investment in domestic production.

5. CONCLUSIONS

5.1. What are the key lessons with regard to access and absorption of resources?

5.1.1. Lessons from Rwanda

In confronting the challenges of design and implementation of domestic revenue mobilization and absorption, the following lessons harnessed from practical experience can be teased out:

- First, shifting the form of external financial support can improve the effectiveness with which development resources are utilized and absorbed. Budget support flows do not require as much administrative capacity as project support.

- Second, developing effective capacity must be pursued over the long-term. In the case of Rwanda, capacity gaps still exist in human resource and financial management with regard to donor-supported projects. These will need to be filled in a coordinated manner as a matter of necessity but will require time to address.

- Third, rapid and sustained capacity development can be enabled by long-term and flexible technical assistance support. For Rwanda, the country has received support from ACBF for its human and institutional level capacity since 1996. Specifically with regard to the revenue authority, it has received substantial support from UK's Department for International Development under a flexible and predictable long-term commitment.

- Fourth, spending and absorptive efficiency are conscious policy and institutional choices. Rwanda's spending and absorptive efficiency improved post-2004 under a stronger policy environment.

- Fifth, Rwanda's sustainable development will depend on its ability to develop its economic infrastructure and expand its administrative capacity, an important problem throughout Africa.

- Sixth, the case of Rwanda shows that governments could reallocated funds from programs with difficulties in absorbing the totality of their budget allocations (e.g. gender and export promotion) to new priority programs (e.g. energy);

- Rwanda has become a "darling" of development partners because of her sterling execution of aid-supported projects and low corruption and political interference, which have caused convergence in her development interests with donors' interests. The lesson here is that recipient countries and donors should develop a mutual working relationship to improve the alignment of donor and government interests and priorities and hence increase on absorption levels.

- Like Rwanda, countries should develop a policy on external aid management. Once developed, the policy should address absorption challenges arising from poor coordination, resource mobilization, accountability, and reporting among others.

5.1.2. Lessons from Botswana

Tax incentives must be cost-effective and sparingly granted. Tax concessions generally rank low in the list of factors influencing investment decisions. Thus, tax reforms in Botswana would ease the adoption of international best practice by assessing which tax allowances and credits would be better at attracting or retaining private investments.

Integrity in utilization of resources. The Botswana government has maintained transparency and accountability in the allocation of tax revenue and mineral revenues to development activities such as human capital and physical infrastructure development. Although income disparities have not been adequately addressed by these developments (poverty levels remain high), it is expected that human capital development will, in the long-term, help address income inequalities as opportunities open up in the services sector.

Invest in human capital. One of the government's greatest achievements has been the provision of almost universal free education, though limited fees were introduced for secondary schools in 2006 as part of cost

recovery measures. Adult literacy increased from 34% in 1981 to 81% in 2006; and net enrolment rate for the 7-13 age group increased from 96.7 percent in 1995 to 98.5 percent in 2004. In the long-term, a large stock of human capital will improve Botswana's capacity to administer implementation of funded development projects and hence absorptive capacity.

5.2. What are some of the key recommendations on the capacities required for mobilizing resources?

Capacity to generate domestic tax revenues. To efficiently and effectively generate domestic tax revenues, countries need to invest in (technological and human) capacity of revenue authorities as part of a broader fiscal reform agenda that includes simplifying and rationalizing tax systems (e.g. reducing tax exemptions and mitigating corruption in tax administration). In this regard, more and better trained staff need be hired and retained and be allowed to work without political interference. Importantly, the capacity of revenue authorities to engage with taxpayers and foster a culture where taxation is seen as contributing to essential services must be built.

Capacity to deal with illicit financial flows. A report prepared jointly by the African Union and UN Economic Commission of Africa suggest that Africa is losing more than USD 50 billion annually in IFFs. This is a conservative estimate because accurate data do not exist for all African countries and for proceeds of bribery and trafficking of drugs, people and firearms, which are secretive and often difficult to estimate. The capacity needs to combat IFFs are mostly human capital to boost abilities in such areas as financial sector regulation and surveillance, crime detection and prevention, forensic accounting, and public prosecution as well as in technology to improve detection and prevention of IFFs (see the 2015 Africa Capacity Report by ACBF).

Capacity of the financial markets to mobilize resources. The Botswana case demonstrates investor appetite for debt instruments. Thus, African governments can effortlessly tap into their local debt markets for development financing. However, in most of Africa, studies show that bond markets are shallow, thinly traded, weakly capitalized, and generally underdeveloped. Governments therefore have the motivation, and the onus, to formulate policies and provide incentives that can spur the development of domestic public debt markets.

Capacity to utilize blended finance. Increased use of the capital markets, official development assistance, and loans from multilateral agencies might not be sustainable if economic growth does not match or exceed growth in public debt. To deal with debt sustainability, most countries impose public debt ceilings. In such situations, alternative, more sustainable financing options, such as public–private partnerships (PPPs) models, have been proposed. The capacity of many African countries to use PPP model is, however, limited. Several solutions have been proposed, including:

1. **Establishing well-resourced and technically competent PPP units that are autonomous or delinked from national Treasuries.** This requires infrastructure (office space, software), human resource and a legal framework, which countries such as Botswana and Rwanda are enacting.
2. **Develop in-house human resource capacity** in public project planning and management to engage the private sector in the PPP process. Rwanda and Botswana have not yet done this but countries such as Kenya and South Africa are in the process.
3. **Public education.** There have been instances when the public has rejected projects especially when user fees are imposed on public infrastructure (e.g. "e-tolls" in South Africa). The masses should be educated about private sector involvement in development funding to deal with such issues.

5.3. What are some of the key recommendations on the capacities required for absorbing resources in Africa?

Public sector human resource capacity. To make local capital markets and other financing options work efficiently, qualified human resources need to provide expertise to drive the processes. In particular, the public sector needs in-house expertise to interact with the markets, and with private sector entities interested in financing development projects. African governments should focus on training, which can be done through short courses, in-service workshops, collaborations with universities; apprenticeships under technical staff from the private sector, seconding of staff to development finance organizations.

Capacity of institutions, legal systems and governance. Africa's institutional quality is still weak on protection of property rights, protection against fraud and anti-competitive behavior, mitigation of risk and management of social conflicts; rule of law and tolerance for corruption. Capacity building needs exist in a wide range of areas.

1. Need for public service reforms, civil service (including police service) reforms, and judicial reforms.
2. Need for initiatives to strengthen monitoring and enforcement mechanisms needed to hold the public sector accountable and build confidence in its ability to deliver services efficiently.
3. Need to develop economic management capacity (budget preparation, macroeconomic analysis, development and implementation and IFM System, public expenditure control mechanisms, etc.)

Project implementation. From the studies of Rwanda and Botswana, it is clear that many countries have not dedicated units to oversee project implementation. Governments should ensure that effective project management units comprising of multidisciplinary officers are established across all Ministries, Departments, and Agencies to improve absorption in donor-funded projects. Project Supervision Committees should also be established. Accounting Officers (e.g. Departmental Secretaries) should enforce compliance with rules and regulations and financing agreements in order to minimize cases of ineligible expenditures.

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