Domestic Resource Mobilization and Public Financial Management

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This is the third in a series of four policy memos that explore various facets of domestic resource mobilization (DRM) and examines the interaction between DRM and public financial management (PFM). DRM is commonly defined as the mix of financial resources available to a government to fund its operations, including direct and indirect taxes, other revenue, and borrowing from local capital markets. This series of policy memos is primarily concerned with the tax or domestic revenue side of DRM and in the two subsequent memos will explore other topics related to DRM: how good public financial management impacts DRM and the political side of DRM. The first two policy memos examined tax system reform and the role of donors. Donors have long provided support for tax reform, but since the adoption of the Millennium Development Goals in the 2000s, donor and recipient governments have increasingly placed local resources at the center of efforts to tackling development challenges. This conversation has gained importance in the last five years as the international development community adopted the more ambitious Sustainable Development Goals (SDGs) in 2015, which aim to end extreme poverty by 2030.

Introduction

The increased focus on DRM by donors is welcome from a resourcing standpoint: a country’s own resources represent the most stable, long-term source of financing available. Reform activities around DRM, however, cannot occur in a vacuum. Simply improving the ability of a country to raise additional tax and revenue from its citizens without ensuring that these resources will be well spent will not achieve the desired development outcomes. This will require a much greater focus on public financial management (PFM). PFM, as defined by the Organization for Economic Cooperation and Development (OECD), encompasses all phases of the budget cycle, including budget preparation, internal control and audit, procurement, monitoring and reporting arrangements, and external audit.\(^2\)

“Good financial management is the responsive, prudent, effective, transparent and accountable management of public financial resources and requires robust budget and financial management,

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audit and oversight institutions that operate within the rule of law.” Donors must approach their support for DRM through a holistic view of PFM and DRM as being intrinsically linked. Bad PFM practices negatively impact a country’s ability to raise additional domestic resources from its citizens. Corruption or wasteful public spending clearly leads to lower taxpayer morale, that is, the likelihood that a taxpayer will be willing to pay his or her taxes. These constraints, as well as others, such as high government turnover and technical training gaps, cause foundational issues for PFM, despite years of capacity building, technical assistance, and aid programs.

As with DRM, PFM is not a new topic for donors. Most have a long track record of working PFM reform through long-standing efforts at capacity building and good governance programs. In particular, multilateral institutions such as the International Monetary Fund (IMF), World Bank, and OECD have provided significant support or guidance for PFM work. The IMF, in its work on PFM, has drawn three primary conclusions: 1) get the basics right; 2) be sensitive to political economic factors; and 3) be prepared to draw on opportunities created by new technologies. Without a firm groundwork in basic, clear, and effective policy, the IMF believes that overly ambitious or advanced PFM reforms will cause upheaval and harm. What are the basics? There are six basics that need to be in place to create a well-functioning PFM system: 1) a clear and accountable budget process; 2) efficient export controls; 3) reliable government accounting systems; 4) independent treasury accounts; 5) fiscal reporting rules; and 6) an independent robust auditing system. Implementing these, though, can be difficult.

In addition to the benefits that improved PFM would have for the broader discussion on DRM, it also plays a role in country ownership and the use of country systems. Country ownership has been a central feature of the discussion of aid/development effectiveness since the 2005 Paris Declaration on Aid Effectiveness where it was first endorsed. This was endorsed through a series of meetings in Paris, Rome, Accra, and Busan that culminated in launching the Global Partnership for Effective Development Cooperation (GPEDC). Country ownership has been broadly defined as donors aligning their assistance with the priorities of developing countries as opposed to their own priorities. As one report notes, “Partnerships for development can only succeed if they are led by developing countries, implementing approaches that are tailored to country-specific situations and needs.” But the GPEDC, and the earlier Paris and Accra declarations, seek to do more than simply ensuring that donors align in-country projects with a local government’s development priorities. The international community has also pledged to strengthen country systems largely by donors making greater use of them as a conduit to deliver official development assistance (ODA) and to build effective institutions. The communiqué from Mexico City states quite clearly, “[W]e agree to invigorate efforts to strengthen and use country systems as the default approach, and promote assessment and dialogue on the extent to which their use is appropriate, consider budget support in the appropriate mixture of delivery

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4 IMF presentation to CSIS working group, October 13, 2015.
5 Ibid.
instruments, continue untying aid, enhance the localization of development cooperation, including by promoting local procurement.”

The use of country systems remains tricky for many bilateral donors. The GPEDC itself captured this fact: “[M]any providers of development cooperation have faced pressures on their budgets and increased domestic scrutiny over the way they spend funding and what such funding can achieve. This has not been without implications for choices regarding resource allocations, modalities for delivery and risk management.” Moreover, it remains to be seen if systems are strengthened by simply using them. In many ways this is the heart of the argument around the push to make greater use of country systems, and yet, evidence to support it remains thin. This is an area where donors—and the GPEDC—need to consider funding priorities at the country level. If the goal is to rely more upon local systems, are donors directing financial and technical support to help reforms and ensure that these systems provide the proper risk mitigations?

This memo will examine the importance of PFM to the broader discussion about reforms around DRM, the practical implications of poor PFM, and how technology can improve accountability.

Public Financial Management

Overall PFM systems remain weak in many, if not most, developing countries. This leaves them vulnerable to corruption and rent-seeking behavior. But the story is more complex. Developing countries have made significant strides since the early 1990s in improving their macroeconomic performance. This was especially true in the countries of sub-Saharan Africa. As Steve Radelet noted in his study, Emerging Africa, “Twenty years ago, nearly all African economies were effectively bankrupt, with large budget deficits, double-digit inflation, growing debt burdens, thriving black markets… and rising poverty.” Subsequently there has been a move toward improved policies, more accountable governance (in many cases democratic governance), and better overall management of the economy. Improved PFM systems through improved spending efficiency or stewardship of public funds can also lead to greater collection of domestic resources by giving citizens a stronger sense that there are clear benefits to paying their taxes.

There have been other outside factors as well. Debt relief also played a role in improving macroeconomic level conditions for developing countries. Following a high-profile campaign by advocates, the G-8 agreed to write-off $70 billion in debt from 39 highly indebted poor countries (HICPs) that was owed to the World Bank and IMF. This effort helped to free up nearly $1 billion per year that had previously been directed toward debt servicing. Not only did this allow these countries to direct these resources toward other purposes, it also allowed a number of countries to borrow

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8 Steven Radelet, Emerging Africa: How 17 Countries Are Leading the Way (Washington, DC: Center for Global Development, 2010), 17.
again on the international capital markets at much-reduced interest rates in comparison to local debt markets. For example, sub-Saharan Africa saw debt offerings surge from $1 billion in 2000 to $11 billion in 2013.9

Overall growth has been strong for nearly 20 years in developing and emerging market economies, but in the last two years or so (especially as commodity prices have decreased) growth has slowed tremendously. Without continuously rising commodity prices and a more difficult international economic picture, countries will need to focus more on improving their PFM processes to ensure prudent fiscal management. Though this could generate political turmoil, it may also reinvigorate efforts at reform. Ghana, in West Africa, has been one of these rising starts that now faces a bleaker future and must make tough decisions going forward. The case demonstrates the complex interplay between rising domestic resources, implementing key principles of good PFM (i.e., debt management and improved budgeting processes), and transparency and accountability.

Case Study: Ghana

The Ghanaian government forecasted that the offshore Jubilee Oil Field, discovered in 2007, would spur economic growth from 5 percent to 12 percent within its first two years. In 2010, the UK-based Tullow Oil company began production of 55,000 barrels per day at Jubilee Field, and Ghana expected a $400 million boost to GDP in the first year of production.10

This optimistic outlook, however, did not take into account the realities of the Ghanaian government’s ability to harness these new funds. While Ghana once represented the strongest economy in Africa, 2012 saw several changes to the status quo. First, the price of gold, which accounts for 5 percent of the country’s GDP and 37 percent of total exports, began to fall, destabilizing a reliable source of revenue for the country.11 Additionally, in an attempt to create more reliable access to power, the Ghanaian government created subsidies and tax breaks for energy companies, which deprived the government of important sources of income.12 Furthermore, a bill to increase the wage rate for government employees came into effect, under which government salaries, allowances, and benefits accounted for 64.2 percent of tax revenue or 92 percent of non-earmarked tax revenue.13

The effects of the wage bill were widespread: the government budget for goods and services fell short by 51 percent; job creation in the private sector slowed; employment in the informal sector increased; inflation increased unchecked; and Ghana was on a trajectory to being unable to raise sufficient taxes to cover compensation alone. The IMF has repeatedly called for the repeal of the

wage bill to no effect. In order to balance the effects of the wage bill, in 2015, the government of Ghana approved the sale of a $1.5 billion Eurobond, 500 million of which would go toward refinancing government debt. In 2016, the government approved an additional $1 billion in 15-year Eurobonds, bringing their public debt to 72 percent of gross GDP. Ghana’s public debt represents 10 percent of Africa’s total debt—$3.5 billion out of $35 billion—and the second-highest public debt in the continent, behind Ethiopia.

This high level of debt has caused the IMF to express concern for Ghana’s financial stability. The IMF has been engaged in a financing agreement with Ghana since April 2015, and is on track to provide more than $900 million over three years to support Ghana through economic shocks, structural reforms, and the aftermath of years of inflation, falling currency values, and increasing debt. Oversight and reform in Ghana’s public financial management plan is crucial to regain control of the country’s budget and ensure economic solvency. The World Bank, IMF, and U.S. Agency for International Development (USAID) all have active projects in the country, and international oversight and direction could improve the financial uncertainty that the government of Ghana faces.

Role of Technology

Accountability and measurement can be central to tax reform and improved PFM practices in developing countries. Technology can play a role in building or extending transparency tools to citizens who can then use them to hold government accountable. Technological advances such as satellites and digital imaging software are useful for collecting property taxes, for example, which improves taxpayer accountability as well as digitizing and creating records of payments. Social media, as well, can be harnessed to create tools to increase accountability of taxpayers; both formal tools (satellites for interpreting land ownership) and informal ones (social media for research on noncompliant companies) should be considered, and a blend of both may be the most effective way to track noncompliance in the tax system.

The Ugandan government, for example, has implemented an online budget portal through which stakeholders at the village or commune level can connect with national-level government to report mismanagement or to request services. This encourages a more intense focus on transparency and accountability to ensure that spending meets community needs. The Tanzanian government has a similar project, a component of the Open Government Partnership (OGP) action plan, which seeks to

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17 Ibid.
improve public transparency and hold governments and citizens accountable.\textsuperscript{21} OGP is a global initiative launched in 2011 that required participating governments like Tanzania to publish tax forms, revenues, expenditures, and tax exemptions online to maximize the resources their citizens could access to learn about taxation.

Applied technology that places a particular focus on women and those living in especially rural areas can potentially improve tax compliance by reaching out to those who previously had no ability to pay taxes. While access to SMS, emails, or call-in lines is available for some of these underserved populations, it is crucial that the person fielding these requests—a government official—is able to promptly reply and provide accurate and understandable information. This could mean that further technical training and capacity programs are necessary to ensure that these new technologies actually benefit citizens. The United Nations Institute for Training and Research (UNITAR) has created training programs on IT application that target young professionals and government employees in developing countries.\textsuperscript{22} Programs that focus on both building human capacity and creating new technological resources for governments can improve the efficacy of technology-dependent tax reforms. It is, however, critical that technology is not the only avenue through which the government is more accessible and provides an inroad into involvement in various tax processes and government choices—enabling active citizenship through town halls, local leadership, and other civil society mechanisms are equally valuable tools.

Transparency and accountability among donors is also important. The international community must create a different style of partnership in the macroeconomic space, featuring a collaborative institutional design and buy-in. Historically, and particularly with USAID programs, the focus has been on accountability to donors, but this could be misguided or outdated. An important consideration for countries like Rwanda and Indonesia is their changing ambitions; they no longer expect or want traditional ODA, but increasingly are instead interested in open dialogue and capacity-building programs, preferring to be seen as partners rather than recipients. Focusing on supporting improvements to the capacity of government to raise revenue and then spend these resources in a responsible manner fits within this evolving aid paradigm.

Conclusion

Developing countries broadly have been the beneficiaries of 20 years of strong economic growth, which has generated new revenue for the state and lifted many out of poverty. In the last few years, however, growth has slowed as commodity prices have fallen and the broader global economy has continued to struggle. Sound public financial management is at the heart of the creation of a strong functioning government and will ensure that gains made through improved DRM are directed toward achieving development outcomes. Raising greater government revenue simply for the sake of more money is not sufficient; ensuring that this money is directed toward the delivery of public goods. By


\textsuperscript{22} UN Institute for Training and Research (ITAR), “CIFAL Shanghai: Training Course on IT Application for Developing Countries,” 2012.
doing this in a transparent and accountable manner, the social compact between citizens and the state will be strengthened. But this will require tremendous political will on the part of developing countries, which will need to tackle the existing barriers to greater reform.

By investing in PFM, donors will help to ensure that the country ownership agenda will continue to be supported. No one doubts that the basic concept of country ownership is critical to successful development interventions; no one doubts that donors should do their utmost to align their projects with the development strategy of recipient countries. But the use of country systems will remain problematic so long as those systems are weak even as this remains a focus for development effectiveness. And, although some argue that simply using these systems will strengthen them, the evidence for this remains inconclusive. This support for use of country systems gives further impetus to improving PFM systems as part of the broader DRM conversation and it may offer an opening for a greater dialogue between donors and recipients over the need for reform.

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