



THE AFRICAN CAPACITY BUILDING FOUNDATION | FONDATION POUR LE RENFORCEMENT DES CAPACITES EN AFRIQUE

CAPACITY BUILDING FOR DOMESTIC RESOURCE MOBILIZATION IN AFRICA

by

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AN ISSUES PAPER

I. INTRODUCTION: THE PROBLEM AND BRIEF OVERVIEW

Policymakers want to increase the domestic financial flows going through channels that could be tapped for 'legitimate' uses. This involves finding ways to increase the volume of financial flows, as a whole, and the percentage of those flows that goes through officially approved channels. Financial flows that do not go through officially approved channels may or may not originate from illegal activities. Country officials are especially concerned when illegal (or illicit) financial flows result in transfers (capital or current account) out of the country, originate from illegal activities, or are used to finance illegal activities anywhere.

Illicit financial flows are typically nontransparent—to tax and official statistics authorities. The money, in turn, is typically obtained via corruption, illegal activities such as trading of contraband goods, criminal activities, and tax evasion, as well as through profits earned from shady accounting practices such as faulty transfer pricing.

African countries have become particularly concerned about illicit financial outflows (GFI, 2013). The UNECA has recently established a High-level Panel (UNECA, 2013) to address the problem of illicit financial flows from the continent, which some have estimated to be around \$50 billion a year in recent years. Mr. Thabo Mbeki heads the panel, which includes nine other persons from both within and outside the continent.

About two-thirds of the illicit outflows from Africa supposedly originate from activities of multinational corporations, while about 30 percent originate from "straightforward criminal activity," including narcotics and human trafficking, as well as corrupt practices. For the most part, the money allegedly goes to the developed countries as well as to tax havens. As part of their work, the UNECA High-Level Panel visited the US to talk to representatives of the US Government, the private sector, academia civil society, and multilateral institutions, on various aspects of the issue of illicit financial flows.

At the recent (April 2014) IMF-World Bank Spring Meetings, African countries asked the IMF and World Bank to help them probe illicit financial outflows from the continent, by way of capacity building as well as prevailing on receiving countries to help stop the practice.

The African countries would like to increase expenditures on education, skills development, infrastructure, and various activities that promote technological progress and innovation. In general, they would like to raise investment and the efficiency of investment, in order to promote economic development and growth. Moreover, regular service provision—law, order, poverty reduction programmes—are in need of additional resources.

This issues paper is concerned with policies to increase financial flows, whatever the source, which are transparent and available for legal use by domestic agents in domestic activities, namely, domestic production, investment and public service delivery.

To summarize, the paper discusses the nature of *domestic resources* that are to be mobilized and the *capacity for their mobilization*. **Six binding constraints are suggested** as retarding capacity-building for domestic resource mobilization:

- Low disposable incomes;
- Pervasive corruption;

- Underdeveloped financial systems;
- Tax policy weaknesses;
- Legal system inadequacies; and
- Low support of the population in addressing some governance problems

The paper groups the policies needed to address these constraints under two categories, namely, *governance challenges* and *systemic fundamentals in economic policymaking to improve growth and development performance*.

To build capacity for domestic resource mobilization, then, the paper effectively calls for a nine-point action plan (with each point being multi-dimensional), namely:

- Address corruption resolutely;
- Improve the policy environment for economic growth;
- Stress private sector development in economic policymaking;
- Address some core financial sector development issues;
- Address tax policy—both tax structure and tax administration;
- Pursue legal system reform— both law reform and the functioning of the organizations and bodies of the system of law enforcement;
- Raise government efficiency in project selection and service delivery;
- Cooperate with international organizations and bodies, as well as with foreign governments, focusing on incentive, regulatory and investigative mechanisms, particularly to fight illicit financial flows;
- Establish, nationally, a cooperative structure—involving government, business and civil society—to address the above issues on a continuous basis

II. DOMESTIC RESOURCES AND THE CAPACITY FOR ITS MOBILIZATION

The *domestic resources* that are to be *mobilized* and for which *capacity* is needed are ultimately obtained via voluntary saving of the population and taxation by government (local and national).

1. Resource Mobilization

The persons and organizations doing the *intermediation job of mobilization* are the taxation authorities; banks and other regular financial intermediaries; stock markets; investment firms, organizations and

companies; and pension and other saving funds. The resources (funds) are mobilized for inter-temporal smoothing of consumption, private and public investment, and public agencies' service delivery.¹

A major challenge for resource mobilization, therefore, is, as much as possible, to find mechanisms to raise revenue from taxation as well as savings from income earners. This means, first of all, that the interests of those who pay taxes and those who save must be taken into account when determining economic policies, especially taxation and financial sector policies. Second, it also means that both government expenditure policy and financial sector policy must enable the funds mobilized to be used efficiently, using criteria of efficiency that would, with appropriate information, be generally acceptable to the populace at large.²

2. Capacity for Mobilization

Capacity, in the context under discussion, has three overriding *determinants*. Policy makers must find a way to influence all these three.

First, capacity is determined by the *ability of the relevant economic agents (in particular, government and financial sector operators) to perform the necessary intermediation tasks* that result in tax receipts and savings.

Second, *national income and output*, being determinants of tax revenue and saving, constitute the second set of determinants of resource mobilization capacity. This, in turn, implies that investment and the efficiency of investment and production matter greatly for resource mobilization capacity.³

Third, a major determinant of resource mobilization capacity is *the willingness of the population's income earners to save and to pay taxes*.

3. Addressing Binding constraints

It is proposed, here, that the binding constraints on domestic resources and on the capacity for their mobilization by government and financial sector organizations are the following⁴:

- Low disposable incomes
- Pervasive corruption
- Underdeveloped financial systems
- Tax policy weaknesses
- Legal system inadequacies

¹ In the case of taxation, the tax receipts are for the provision of well-known public services desired by the population, as well as for investments, especially in education, skills development and infrastructure, which help boost economic growth. In the case of non-government financial intermediaries, the funds raised mainly support private individuals and businesses in optimizing consumption flows over time as well in financing investments (working capital, equipment, and training) for production.

² In the case of government, some explicit criteria could be used in the allocation of funds—for example, by applying cost-benefit analysis.

³ See Barro (1997) and Johnson [2012(1)] for an introduction to the determinants of economic growth.

⁴ One should always bear in mind that the intermediaries, in turn, are raising these funds, to assist the users of the funds (government, citizens and businesses) in optimization of consumption over time, investment for economic growth, and the provision of regular government services.

- Low support of the population in addressing governance and development problems

To address these six constraints, policies are needed to overcome certain governance challenges and to deal with systemic fundamentals of the economic policymaking environment. The governance challenges include control of corruption, legal system reform, reform of tax policy especially administration, and enhancement of government efficiency. The systemic fundamentals of the economic policymaking environment will address, in particular, productive capacity building of firms, microeconomic incentive systems, macroeconomic management, and financial sector development and regulation. Finally, cooperation, both at the international and national levels, is essential to success of the programme to address the constraints.

III. GOVERNANCE

In the drive for good governance, it is necessary to *put in place processes, rules, and organizational arrangements* to ensure that optimal policies (given the objectives) are put in place and implementation is as full and complete as possible. This requires appropriate leadership and cooperation [see Johnson 2012(1)].

Cooperation is the willingness to communicate, negotiate, and reach agreement, on the design and maintenance of institutional and organizational arrangements, procedures, and mechanisms, including how to share the ensuing benefits and costs, without fighting, coercion, or total domination by one party. Cooperation, properly managed, will help in building domestic support (and hence legitimacy) for resource mobilization and economic development policies in general. As regards economic development, a very effective way to proceed is to have the cooperation aim at designing and fully implementing a development programme that is nationally legitimated. Such a programme will contain policies that address governance and systemic fundamentals. For most African countries today, such a development programme should stress economic diversification and private sector development. The *national political leadership* could galvanize and mobilize the population and businesses.⁵

When one talks about **institutions** as *rules* governing behavior, one of the operational requirements is *legitimacy*. Institutions that are not legitimated by the populace at large will not be willingly obeyed and promoted by the people; in short, there will be no sense of loyalty to the institutions. Hence, a country needs to find ways to make sure that the rules are legitimated.⁶

As regards **organization**, special attention needs to be paid to two particular organizational issues in this context, namely: (1) the organizational structure best suited to achieve the tasks at hand (for example, including specific incentive schemes); and (2) capacity building to ensure that the tasks assigned to a particular organizational body can be accomplished (which has implications for staffing, training, salaries and equipment).

⁵ Such leadership will need to use *self-interest* and *trust* very effectively in combination with what is often termed *focal points*—typically embedded in the cultures and history of a country—to bring people together to support the national objective(s). Self-interests have taken the form of *collective self-interests* (economic growth and transformation), *business self-interests* (profits and firm growth) and *local political leadership self-interests* (material rewards to local officials for implementing policies).

⁶ In all such situations, legitimation involves citizens' consent without coercion. Such consent comes via several procedures, namely, open discussion and deliberation, voting, and overwhelming demonstration of support in parliament, in the newspapers, and in civil society voluntary organizations. The paper by Giuliano, et al, (2013) is interesting in this context.

IV. ADDRESSING THE MAJOR GOVERNANCE CHALLENGES

The major governance challenges to be discussed are: (1) control of corruption; (2) legal system reform; (3) tax policy reform; and (4) achieving a high level of government efficiency.⁷

In the difficult “fight” with the agents of illicit financial flows and their associated activities, institutional and organizational arrangements are resolutely being put in place to facilitate adequate international cooperation.⁸ Thus, it is possible for African countries to focus most of their efforts on reforms in their own legal, taxation and financial systems, and especially on controlling corruption.

1. Corruption

Control of corruption via appropriate rules, processes and organization will go a long way to solving the problem of illicit financial flows. Indeed, the role of corruption has been grossly underestimated because the amount of illicit financial flows attributed to corruption has been simply classified as “the proceeds of theft, bribery and other forms of corruption by government officials.”⁹

But corruption of such officials is the main *enabling factor* permitting criminal activities, tax evasion, and money laundering, for example. In addition, bribery and theft of high-level political leaders is often downplayed in many discussions of illicit financial flows. In brief, behind a very high fraction of illicit financial flows in the African context is corruption at the highest political levels (political leaders), in government ministries (especially personnel at the highest levels), and government departments and agencies (ports and customs, tax revenue agencies, auditors, police and legal personnel).¹⁰

The importance of controlling corruption can be easily appreciated by simply reflecting on how the funds get transferred and the nature of the activities involved. Some set of officials in a position to report and/or forestall the transfer and/or the exchange activities will typically have knowledge of it/them. The decision to ignore or to cooperate in the transfer and/or the exchange activities, even though they are illegal, is an element of corruption. The amount of the bribes is an underestimate of the contribution of corruption to the activities involved.

Another important point is that, because much of the world is aware that corruption is a major contributory factor to illicit financial flows from the African continent means that developed countries, in particular, will not be enthusiastic in taking steps to help the continent as part of the fight against IFFs until they see major progress in African countries in fighting corruption.¹¹ This is especially because, if important leaders in the

⁷ An excellent read, in actual experience of successful good governance would be Lee Kuan Yew (2000), particularly Part I (Getting the Basics Right, pp 1-223).

⁸ See, for example, the publications, cited in the references, of FATF, UN, OECD, Hague Institute for Global Justice and the US (Patriot Act).

⁹ See UNECA (2013), which also criticizes this definition.

¹⁰ The UNECA (2013) report takes a similar view by describing corruption as a ‘conduit’ for illicit financial flows.

¹¹ As stated in OECD Issue Paper (2013, p.3): “Illicit flows are a symptom of deeper governance failures, and are just one element of a wider set of challenges faced by many countries. High levels of corruption, combined with weak institutions and sometimes illegitimate regimes, are drivers for such outflows. Ultimately, the fight against illicit flows from the developing world must focus on building responsive and effective institutions which deliver services to their population. This will encourage citizens and companies to engage in legal activities, report their earnings and pay their taxes and dues in accordance with national laws.”

African countries are involved in the sort of corruption that underpins IFFs, then it would be extremely costly to make even a small dent in restraining IFFs (e.g., via technical assistance), because the appropriate cooperation from the authorities of the particular African country concerned will not be there.

It is also well-known that *corruption, especially government corruption, is a major factor behind slow growth and development* in the African continent and hence behind low per capita income.¹² This in turn will, therefore, adversely affect the resources available to be mobilized for rapid development.

1.1 African governments' official stance towards corruption

African governments seem to be doing something positive to address the problem of corruption.

First, all or almost all of them have signed on to, and appear to be making efforts to implement, the *African Union Convention on Preventing and Combating Corruption*, the *UN Convention against Corruption*, and the *UN Convention against Transnational Organized Crime*.

Second, in keeping with these conventions, a certain set of headline measures have been highlighted for implementation by these authorities. To start with, a core element of the code of conduct for public officials in some of these countries has become the declaration of assets, and African presidents also, these days, tend to have a declaration of zero tolerance for corruption. Anti-corruption agencies have also become fashionable and corporate governance is receiving some attention in more and more African countries, with the purported aim of pressing for some generally accepted code of good business ethics that meet international standards of good practice. In addition, procurement legislation is being passed or updated in more and more of the countries, formally enshrining practices and procedures conforming to good and generally accepted international standards—typically with technical assistance from the *World Bank* and/or other international partners in development.

Moreover, African governments are cooperating with *Transparency International*, the *OECD* countries and various nongovernmental organizations, trying to give the impression of concern for governance issues, in general, and in particular various aspects of controlling corruption. For instance, the British launched the *Extractive Industries Transparency Initiative* in 2002; the objective is to find ways to make transparent all payments of companies to governments and all revenue received by governments from companies, in the area of extractive industries. The African countries in principle all support this initiative and promise to help make it a success.

1. 2. Implementation problems

Laws and conventions, of course, need to be resolutely implemented to achieve their objectives. Despite all the formal institutional and organizational actions taken by the African countries, in light of the above conventions, corruption has been very difficult to control and indicators of the perception of corruption are not making much dent in these countries. There are well known implementation and other problems that account for this difficulty in reducing corruption in the continent.

First, there is inadequate appreciation by ordinary Africans of the economic costs of corruption, because of a focus on the distributional aspects of corruption and a neglect of its effect on economic growth. At best,

¹² For the theory, see Johnson (1975). For some empirical evidence, see Mauro (1995).

the ordinary citizen will appreciate that a good fraction of the money stolen gets siphoned off into foreign countries rather than being invested in the country concerned. This growth effect they can understand. What the ordinary citizens do not fully understand is that the attempts of the governing team of politicians, and their allies in the government bureaucracy, civil society and the business community, to capture corruption revenue magnify distortions and misallocation of resources in the economy as well as discourage investment, with serious adverse growth effects. The general point is that in a country where public sector officials and employees can get away with corruption, because of weak institutions or weak enforcement of the rules, there is substantial expected and realizable corruption revenue from holding office. This has behavioral consequences that cause aggregate output loss to the rest of the society to be of greater magnitude than the real revenue realized by those who share in this corruption revenue.¹³ The effect of the corruption is not simply distributional.

A second factor adversely affecting implementation of policies to control corruption is unenthusiastic public support of many anti-corruption efforts, because of the belief among ordinary African citizens that corruption cannot be avoided in view of low salaries.

Third, adversely affecting implementation is the fact that ethnicity is rife. Ethnicity creates an incentive for redistribution of state resources to one's ethnic group members.¹⁴

Fourth, affecting implementation of formal anti-corruption prescriptions of the countries is the fact that corruption persists at the highest political levels.¹⁵ The consequence is inadequate political support for anti-corruption agencies and unequal enforcement of laws. The greatest dilemma in the attack on corruption in the African continent today is how to create effective institutions (that is, rules) to control government corruption when those who wield the greatest power in fashioning those institutions, namely the political leadership in these countries, also happen to be the ones who benefit the most from corruption.

Fifth, implementation is made difficult because sometimes the legal framework is not sound and/or the organization for enforcement is confused, typically with unclear and overlapping functions and authority of several agencies involved.

Sixth, the capacity (both human and material) of anti-corruption agencies is, too often, inadequate. This is aggravated by poor lines of communications with government departments and lack of contact with, and transparency to, ordinary citizens and civil society groups that can be of value in getting information and evidence.

Seventh, proving crimes beyond reasonable doubt is rarely easy when it comes to corruption. Eighth, whistle blowing is not looked kindly upon in many quarters. Again, the feeling among ordinary persons that corruption cannot be avoided because of low salaries makes whistle blowing accepted only for enemies or those considered too greedy in their corruption practices. Finally, stolen assets are often placed in the names of relatives, and/or for 'safe-keeping' in the hands of trusted relations and friends.

¹³ See Johnson (1975).

¹⁴ See, e.g., Easterly and Levine (1997) and Gören (2013).

¹⁵ See Johnson, (2004).

1.3 Implications

A number of the above core factors explaining implementation problems may not be easy to eliminate in the near future. The capacity problem is, perhaps, the easiest one to resolve. Budgetary support (some of it obtained via aid), for salaries, logistics, education and training, can help in this capacity building, once the appropriate *political will* and *support from the population* are there. At that point, technical assistance can be obtained in fashioning rules, processes and organizational structures sufficiently effective to address corruption resolutely at all levels. For example, asset recovery is an area where countries have had difficulties in achieving results without painful time and money. Technical assistance can be obtained from many bilateral sources, as well as from international organizations—for instance, via the Stolen Asset Recovery Initiative (StAR) of the World Bank and the United Nations Office on Drugs and Crime (UNODC). StAR supports international efforts to end safe havens for corrupt funds, working with developing countries and financial centres to prevent the laundering of the proceeds of corruption and to facilitate more systematic and timely return of stolen assets.¹⁶

The other obstacles to implementation of corruption control initiatives are more difficult to remove. It is easy to see that the overriding reason for this difficulty is the need for *political will of the political leadership* and *resolute support and cooperation of the populace at large*. To begin the process of removing these binding constraints to controlling corruption, essential will be national *leadership* at all levels—political, civil society and business.

2. Legal system reform

Legal system reforms should aim at law reform, where the laws are inadequate, as well as improving the functioning of the organizations and bodies of the system, where such functioning is poor. The intermediate objectives, from the economic development and growth perspective, are to reduce crime and criminal activities of all kinds; increase the efficiency of business regulation; and to make the general environment for doing business more attractive.

Not surprisingly, curtailing illicit financial flows will be a major motivation within these objectives—both in law design and in law enforcement—and hence a major indicator (within the set of criminal activities) of success in implementation. The ultimate objective of the whole process would be to bolster economic growth, in the country, via increasing the financial flows available for use in production, investment and government service delivery.

African countries have been continuously undertaking *law reform*, since independence. In fact, many of these countries have law reform commissions. Hence, it has been an institutionalized process for the most part. At this level, the most important thing one can say, as a matter of advice, would be that these law reform processes focus immediately and resolutely on the most important issues, given the agreed national economic, political, and social objectives. This advice takes into account the fact that the inadequacies and shortcomings of the laws differ from country to country.

¹⁶ See World Bank and United Nations Office on Drugs and Crime (UNODC) <http://star.worldbank.org/star/>

Improving the *functioning of the legal systems* would most typically involve reducing delays and corruption.¹⁷ Delays result from slowness of investigators including the police; case overload in courts; and repeated adjournments of cases (for example, because certain witnesses fail to show up for reasons including not being given timely notice). Corruption is a major factor behind poor functioning of the systems and is often the main cause of delays.

Better *implementation of the laws in the books* would also improve the functioning of the legal systems. Here capacity is a common problem. In brief, this is typically a problem of low capability, to do their work, of the persons and organizations responsible for investigations and bringing charges, namely, capability to seek and obtain the necessary evidence; to correctly understand the nature of the appropriate charges that have a strong chance of being successfully prosecuted; and to assemble the witnesses and find a way to get them to court. As a result, charges may not be filed when they should; the wrong charges may be filed; or cases may be filed when they are in fact very weak.¹⁸

Illicit financial flows have become prominent in the drive for legal reforms, for at least three reasons: the amounts involved can be very large in relation to gross domestic product (the stakes are high); they typically involve some very powerful persons (humans and organizations); and they often require cooperation among several national legal jurisdictions.

3. Tax policy, administration, and reform

From the beginning of their independence, African countries have been struggling with tax policy and particularly with the element of *tax administration*; of course, even *tax structure* has been a serious problem for those countries.¹⁹ The *informal sector* enterprises have always been difficult for taxation authorities, with respect to both tax assessment and tax collection. But so have been *retail, wholesale and private professional activities in the formal sector*. *Property taxation* is difficult both with respect to tax structure and administration for reasons such as unclear titles, underdeveloped property markets, and corruption.

As regards **tax structure**, even *presumptive taxation*²⁰ has been difficult to yield as much tax revenue as it could, in this sort of environment, partly because of technical constraints and lack of transparency on the part of the businesses concerned, but also because of corruption. Lack of proper accounting (important for income, sales and value-added taxation, in particular), and unclear accounting rules for the taxation system itself, have also bedeviled taxation of small businesses in many countries. For the same reasons, *withholding* has not been aggressively used but rather tends to be confined to employees of government, state enterprises and large formal sector firms. How to address failure to pass on tax collections, particularly in the case of sales taxes, is also a real challenge.²¹ Finally, as well-known, even in developed countries,

¹⁷ See Varvaloucas, et al (2012), for a case study of Sierra Leone.

¹⁸ See Varvaloucas, et al, op. cit.

¹⁹ Tax policy is about 'what to do' and tax administration about 'how to do it.' See Bird (1992, p. 189) on the history of this characterization.

²⁰ *Presumptive taxation* involves the use of indirect means to ascertain tax liability. The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method. See, for example, Vol. 1, Ch. 12 of Thuronyi (1996).

²¹ In the case of sales tax, a common occurrence is for the seller to offer two prices to the buyer—with and without receipt—with the price without receipt being such that what would have been sales tax is split between the two parties. The seller gets the additional benefit of being able to avoid profit tax.

deliberate *tax evasion* (which undermines horizontal equity of the tax system)²² is a tax administration capacity problem, which typically is addressed through periodic auditing.

For tax structure, then, the main intermediate policy objectives of reform should, in principle, be widening the tax base and putting in place tax instruments that could lead to an increase of yields close to their potential.²³ Both here and in tax administration, the tax reform process should not simply be a once-for-all programme. Policymakers must be in a position to alter and adjust policies in reaction to new information, changing circumstances and policy objectives—at each stage making sure that the basic tax law is well designed, taking due account of the administrative realities of the country. This means that the tax reform process would benefit from some degree of “institutionalization.”²⁴ The typical African country, which needs to do so, has access to many sources of bilateral and multilateral assistance.²⁵

Unfortunately, to emphasize, *corruption* (ongoing and potential) looms large, particularly in the area of tax administration. Hence, here again, addressing corruption should be a central part of the whole process.

In **tax administration**, as a general comment, a problem faced by the typical African country, which seems to need special attention, apart from corruption of course, is identifying and keeping track of persons who should normally be liable for taxation. Again, here the problem is mainly with the informal sector. Many of the enterprises are not registered and operate in locations which are not identified as business addresses. Somehow, incentives could be created for such businesses voluntarily to become transparent, including by registering officially. One strategy could be to enable the businesses and their proprietors to participate in national insurance and pension schemes, and then advertise this widely, while keeping taxation rates low. To make this successful, of course, apart from keeping tax rates ‘low’ in accordance with popular consent, the persons involved must also find the national insurance and pensions schemes in their interest to participate.

As regards **organization in tax administration** at the governmental level, special attention needs to be paid to two obvious organizational issues. One is the *organizational structure best suited to achieve the tasks at hand*. In the African context, as with some others around the world, this would seem to include *incentive schemes*, such as privatization of some collection functions and linking reward of agents to collection, and having *an organization that leaves little or no discretion to individual tax officials* in their dealings with taxpayers.²⁶ The second issue requiring special attention is *continuous capacity building*—staffing, training, salaries and equipment— to ensure that the tasks assigned to a particular organizational body can indeed be accomplished at a high level of efficiency.

Tax policy reform must include actions to increase **societal support** for the policy. In many countries in Africa, the taxation system is not sufficiently supported by the population at large, for two reasons. One is a general feeling in the population that tax revenue is not efficiently and honestly put to good use (service

²² In horizontal inequity, recipients of equal income are not taxed alike in practice.

²³ For *robustness*, it has always been a good recommendation that tax reform proposals contain policies that have a high probability of producing the desired results (especially in terms of revenue yields) and also take into account the administrative requirements in relation to the capacity in the relevant context. For a discussion of these and other issues in tax reform, a short introduction can be found in chapters 14-16 of Bird (1992).

²⁴ Bird (1992, p. 185) makes this point as well.

²⁵ See, also, Goode (1984) and Thuronyi (1996, 1998).

²⁶ See, e.g., Bird (1992, p. 198).

delivery and economic development). The other, prevalent among those being assessed to pay, is that the system is not fair.²⁷ Unfortunately, this situation can only be remedied by improved government policy environment and outcomes (service delivery and economic development) and not by preaching to, or doing more “education” of, taxpayers and the population at large.²⁸

To underscore the point, government taxation needs *legitimation*. Hence, government should pay attention to transparency issues (related to revenue, expenditure, and access to information); resolutely address issues of corruption and government efficiency; and demonstrate adherence to, and hence application of, internationally acceptable equity principles in taxation.

4. Government efficiency

For domestic resource mobilization, government *technical efficiency in service provision*—quantity and quality of services per dollar spent on labour and capital in government—is important.²⁹ But so also is the *process of selection of the services* that are to be provided by the government. The selection process matters, because, unlike markets, individuals cannot often decide not to pay for government services they do not want (whether because of quality or because of taste).

If all individuals voluntarily contribute to the services being provided—for example, a toll road or any service provided by government for which there is full and direct individual payment—then the success of an operation will depend on the efficiency of the government provider, given the demand for the services, unless there is a monopoly and hence no direct alternative for the product or service being provided by the government.

The problem of government efficiency is very important, then, because taxation is typically used to finance government services.³⁰ The defenses left to the citizen are: the political vote for government representatives, protest, and tax evasion. It is easy to see that tax evasion is the most powerful of these three for the average individual citizen. The government, therefore, has a huge stake in being efficient in the provision of services and in making sure that the services it provides are ones that the citizens overwhelmingly would want it to provide. The quality of the rules, processes and organizations designed to ensure a high degree of government efficiency are therefore very important in ensuring adequate incentives to voluntarily pay taxes.

Governments that want to ensure good governance in this area tend to introduce certain types of *governance processes*. First and foremost, they would make as transparent as feasible, much of their objectives, resources, and organization designed to accomplish the important tasks of government, as well as their actual performance over some stated period in achieving specific objectives. Second, they would subject the ministries, departments and agencies (MDAs) to oversight and periodic assessment by Parliament and/or some autonomous public body/bodies or organization(s).

²⁷ Bird (1992, p. 194) has termed this sort of predicament an *environmental defect* of the system.

²⁸ In other words, ‘show, not tell’ should be the driving force behind the actions to increase societal support for tax policy. Still, the government should be “open” as regards information and access, to allow whatever it is doing to be known and understood by the population and to enable the population to offer suggestions and justified criticism.

²⁹ For those interested in some technical aspects of the determinants of government efficiency, the paper by Hauner and Kyobe (2008) are of some interest.

³⁰ In other words, the contribution to the service supply is compulsory.

In addition, to enhance *credibility and transparency*, there are a number of steps that governments can, and sometimes do, take. One such step is to subject MDAs to performance contracts, including relating pay, promotions and other perquisites of senior officials to the performance of sectors and geographic areas under their governance or management. Another step is to maintain a reasonably high degree of openness and consultation with major groups in the country with substantial interest in the services being provided—such as business groups, labour organizations, and civil society persons and organizations (the last including academics, journalists and nongovernmental organizations).

Governments, in the interest of efficiency, also make efforts to streamline bureaucracies, particularly via decentralization—political, administrative, and/or fiscal decentralization, as deemed feasible and rational.³¹

Finally, in the interest of efficiency, governments are more and more willing to privatize certain functions (provision of services) or to jointly provide the services with the private sector—so-called public-private partnerships. This has been especially true in the area of infrastructure. Increasingly governments have been letting the private sector into the financing and the management of infrastructure projects and services,³² via full privatization or various types of public-private partnership (PPP) arrangements. This has been spurred by public sectors facing serious financial constraints to make the investments in the projects and to afford the necessary technical and managerial capacity, including in-house expertise, to efficiently operate the particular facilities.³³

V. SYSTEMIC FUNDAMENTALS: ECONOMIC POLICYMAKING ENVIRONMENT

Imagine a situation in which the policymakers do nothing to attract illicit funds but have coherent policies to attract private funds—irrespective of their origins—to save and invest in legal activities in the local economy. Such a policy approach could also be socially optimal, given limited capacity to fight illicit fund transfers. The policy framework will especially contain a number of well-known elements that promote private sector development. This will help reduce the incentive to take funds out of the economy (legally or illegally).

In brief, the authorities need to take steps to strengthen the economic policymaking environment and make the economy attractive to strong firms, to produce and to invest in the country, as well as to savers to keep their funds in the country. A sound economic policy environment will bring about a virtuous circle by raising investment and the efficiency of investment and hence economic diversification and growth, thereby increasing the capacity to generate resources for taxation, saving and investment leading to further economic growth and capacity building for still further rise in domestic resource mobilization.

³¹ For an introduction to the basic economics of decentralization, see Bardhan (2002), Frey and Eichenberger (1999), Johnson [2012(1)], Qian and Weingast (1997), and Rodden, et al, (2003).

³² Interesting and useful reading, here, is Weber and Alfen (2010).

³³ In all such cases, including infrastructure, the authorities will need to do studies to come up with guiding principles on the appropriate governance arrangements (rules, processes, and organization) with respect to: ownership, investment financing, management, pricing of services with or without government subsidization, competition policy, and regulation. From these principles would emerge, inter alia, the kind of cooperation that the government decides (finds optimal) to have with the private sector.

The policies and actions to achieve the main overriding intermediate objective (private sector development) will need to address so-called ‘*neutral fundamentals*’ in the economic environment as well *business regulations*. Such policies will favorably influence the so-called *ease of doing business*. In a complete policy framework for private sector development and economic diversification, the authorities will also design some *selective intervention* policies to supplement the neutral fundamentals, depending on the circumstances of the country; the selective interventions will address certain binding constraints in this general area.³⁴ This paper will not get into that subject matter.

The policies to get certain neutral fundamentals right must address, especially: (1) enabling factors that help build the productive capacity of all enterprises in the country; (2) microeconomic incentives to facilitate and to attract strong enterprises; (3) macroeconomic management; and (4) financial sector development.³⁵

1. Productive capacity building

Factors that significantly affect the ability of firms to raise their productive capacity include especially: (1) the quality of the national innovation system, (2) the human capital in the system, and (3) various forms of infrastructure. Government policymaking needs to pay particular attention to these factors.

1.1 Innovation system

The concept of a *national innovation system* is useful in ordering one’s thinking in this regard (See, e.g., Nelson 1993, Oyelaran-Oyeyinka and McCormick 2007, World Bank 2010). A national innovation system is the set of institutions, organizations, and mechanisms supporting innovations (technological and other innovations) within firms and industries in a country. Here, one is interested in the processes by which firms in the economic system master procedures, techniques, and technology that are new to them, some of which they may have invented themselves and others simply copied from different firms within and outside the country.³⁶

An objective of a policy on the national innovation system is, in short, to enable domestic firms to develop sufficient technological, organizational, and scientific sophistication and adaptability to function effectively when compared with some other firms in the global environment.³⁷ As part of the focus of their policies, the

³⁴ Seven such binding constraints have been highlighted in the literature (see, e.g., Dinh, et al, 2013). These are (1) the availability, cost and quality of inputs; (2) infrastructure—especially electricity, but often also water, telecommunications, and land transportation; (3) access to land, especially for industry; (4) access to finance; (5) trade costs and logistics, due especially to invisible infrastructure, and to limited knowledge, experience and network in commerce; (6) entrepreneurial capabilities, both technical and managerial; and (7) worker skills.

³⁵ See, e.g., Campos, et al (1996), Kim (1997) and Dinh, et al (2013), for good development success stories (in East Asia), in the wake of sound policies to diversify the economies and promote private sector development and exports as well.

³⁶ See the excellent study of the Korean case by Kim (1997). Innovation, thus, involves inventing or simply copying and catching up with products and practices of others; appropriate adaption of existing products to the specific clients and/or environment; investment in new equipment; organizational reforms; learning new skills, including technical and analytical knowledge; and adopting new approaches in marketing and cooperation with other firms.

³⁷ Strengthening the national innovation system would involve looking at the quality of secondary schools; programmes at universities, research centres and institutes; technical and vocational training in the country; and training and research facilities and programmes within domestic firms. Government policies can influence all of the elements that affect innovation, as can cooperative arrangements among firms and organizations in the system.

authorities should try to address habits and practices affecting the *willingness and ability of major actors in the economic system to innovate or to support innovation*.³⁸

1.2 Human capital in general

The quality of the human capital in the economic system will be crucial.³⁹ Indeed, many of the policies being implemented to boost the economic development of the country will be designed with an eye to attracting high quality personnel. African countries should be open to firms from all over the world.⁴⁰

Difficult issues arise in the areas of *labour policies* and *personal income taxation*. In the case of labour policies, the main issue is the degree of freedom and flexibility that the top management of firms will have with respect to hiring and firing, overtime pay, minimum wage, leave, treatment of unions, and hiring of foreigners at all levels of the firm. A highly recommended approach of African countries would be to take a survey of what leading economic powers and rapidly growing developing countries are doing at the moment and adopt an appropriate mix of policies. The same can be said for personal income taxation.⁴¹

1.3 Skills training

A very important area of human capital development that is proving difficult for many African countries is technical and vocational education and training (TVET). This has been due mainly to institutional and organizational problems, uncertainty as to how to address certain difficult policy issues, and finance constraints. African countries need to review their TVET policies and to revise them, if necessary, to ensure that they are coherent enough to foster rapid private sector development, while ensuring that any policy intervention is effective in terms of value for money.

The main objectives of the policymakers should be: (1) to improve *participation* of potential candidates in the national TVET programme; (2) to increase *formal employment* of participants; and (3) to increase, substantially, the *earnings* of participants after completion of training. In this regard, there are many issues to be addressed including the institutional and organizational environment of the TVET programme as a whole and about the nature of government intervention.⁴²

³⁸ In that regard, the *incentive structures* within the economic system as a whole and within firms and organizations matter. Appropriate incentives will particularly encourage innovation and survival of only strong firms which tend to be more innovative. The *competitive environment* is also important, and hence national policy fostering open markets and safeguarding their integrity will be good for innovation. *Labour-management relations* matter, inter-alia, because they can influence employees' attitudes and commitments towards technical change and innovation. Moreover, *availability of finance to support innovation* (especially acquisition of equipment and training) is extremely important.

³⁹ The technical capability, innovative ability and integrity of the human beings operating in the system and overseeing its markets and organizations are important dimensions of this quality.

⁴⁰ International firms and conglomerates thrive on their diversity and their ability to rotate their employees worldwide.

⁴¹ As to the level of taxation, the advice again to any African country should be to do a survey of some leading economic powers and rapidly growing developing countries and get a good idea of their personal taxation, both of nationals and of foreign nationals who are residents in the countries. Then an attempt should be made to modify the country's taxation laws to become competitive internationally.

⁴² For an excellent introduction to the issues and the challenges in the African context, see Johanson and Adams (2004). Technical and vocational education and training should always be responsive to the market. Thus, to begin with, the African country's authorities should make sure that *they understand important elements of the labour market*. The *information available to potential trainees* about returns to training is also useful. In this broad context, a *labour market observatory* could be useful to establish if the country does not already have one. The observatory will develop information about the labour market and be willing to share the information with private trainers and potential trainees.

1.4 Infrastructure

Infrastructure produces commodities and services very essential to production in the other sectors of the economy. All rapidly transforming developing countries have rightfully stressed infrastructure development.⁴³ Within the public sector, the central government and the local governments should normally have clear functions, specified in law, regarding the provision of infrastructure and other public services. The organizational requirements, including optimal decentralization, can be challenging.⁴⁴ African countries, particularly in their attempt to promote private sector development for economic diversification, need to address a number of important topics in this area, with technical assistance as they consider useful.⁴⁵

2. Microeconomic Incentive System

The microeconomic policy environment will affect the economic returns to the people and firms that operate in the system. If these returns are low by world standards, people and firms that can earn higher returns elsewhere will leave, until an appropriate stock is left, such that the marginal returns to those who stay equals the returns they could earn elsewhere.⁴⁶ Some of the microeconomic incentive issues have already been addressed when discussing human capital. In addition, one can mention here that the quality of life also matters in attracting talent. Hence, making the country attractive to live in will be a positive incentive to enterprises. Also important are issues of openness, administrative barriers, taxation, and the legal environment—all of which will require the attention of the country authorities.⁴⁷

The authorities would need to come up with *governance arrangements that foster cooperation of government, business, and other non-government trainers*, including national coordinating bodies, and national training authorities. Apart from issues related to the institutional and organizational environment, there are also important *questions in five specific policy areas* that have become a focus of discussions of TVET in the African context: (1) whether or not to *add vocational training to the academic curriculum*; (2) *the role of government in TVET*; (3) *the role of the formal nongovernment sector*; (4) *the design and management of skills development for the informal economy*; and (5) *the highly important area of financing skills development*, which involves both resource mobilization and allocation mechanisms.

⁴³ For the case of Malaysia, as an example, see Salleh and Meyanathan (1997).

⁴⁴ Infrastructure products are sometimes grouped by various authors into: (1) *physical infrastructure*, such as airports, oil and gas pipelines, ports, railway, roads, renewable energy plants, power companies, waterworks, and waste disposal companies; (2) *social infrastructure*, such as administrative buildings, schools, hospitals, sport facilities including arenas and stadiums, cultural facilities including theatres and museums, and public facilities including public housing and pools; and (3) *invisible infrastructure*, which essentially are automated procedures, software and systems—information and communication technologies (ICT)—that simplify and speed up data management, processing and communications in economic transactions. See, for example, Weber and Alfen (2010) and Staples (2002).

⁴⁵ Most important among these topics are: (1) the physical state and general performance of the country's infrastructure; (2) the levels of government spending on different types of infrastructure—in absolute amounts and also relative to GDP; (3) characterization of the governance of the major subsectors, along the lines of (a) the organization, competition and regulations that affect the operations of the subsectors, (b) investment financing of the subsectors, and (c) current private sector involvement in financing and in operations of each of the subsectors; (4) proposals for changes in governance that could be beneficial for development and efficiency of the sector—for instance, permitting greater private sector participation than in the past; (5) assessment of investment risks in the country's infrastructure and the implications for public versus private financing of infrastructure investments; (6) how *effective demand* for major infrastructure services in the country can be estimated for planning purposes; (7) policy issues in determining and ensuring *optimality in supply and pricing* of various infrastructure services; and (8) management and governance issues in ensuring *optimal maintenance of infrastructure facilities*.

⁴⁶ Strictly speaking, these are returns after adjusting for risks, of course.

⁴⁷ For an earlier discussion along the same lines, with special application to financial sector reform, see Johnson, 2012(2).

2.1 Openness

The economy will benefit from the presence of strong firms—by definition, firms that can survive in open competitive markets and many of which can build the capability to export their internationally tradable commodities and services. In order to attract or help such firms to emerge, an overarching requirement is the maintenance of an economic environment (markets, institutions, immigration laws, information flows, ideology, and access to the authorities) that is open.

2.2 Administrative barriers

There clearly should be concerted efforts made by the country authorities to reduce administrative costs and barriers to establish and operate a business. In brief, the barrage of licenses, approvals, permits, and other requirements should not unduly raise the costs of setting up and doing business in the country. In addition to legal and organizational improvements to simplify and speed-up processes, the authorities, resolutely, should monitor implementation—of the rules, including laws, on doing business—since this is one area where corruption is often rife in the business environment.

2.3 Taxation

If there is one mantra that policymakers in Africa should embrace in the taxation area, in their quest to attract strong firms and investors, it is to keep taxation ‘reasonably low’ by world standards.⁴⁸

It is useful for the country authorities to see the taxation problem as one in which they are trying to promote production, enable the economic system to attract and keep talent, and to attract foreign direct investment, including via *value chain relationships*.⁴⁹ Hence, the taxation of the firms must not do damage to the competitiveness of the local environment in all these dimensions.⁵⁰

2.4 Legal environment

The law, the courts, and the police all need to be reviewed in light of the requirements to make the economy grow, and become more efficient and competitive. Delays, corruption, lack of clarity in the law, poor implementation and high enforcement costs all have adverse effects on incentives and transaction

⁴⁸ Taxation systems around the world include corporate taxation; taxation of wages, salaries, interest, and dividends; taxation of capital gains; and taxation of specific transactions. Then, of course, there are various categories of taxes, in the form of fees, which are not typically labeled as ‘taxes.’ Rather they may be called registration fees, stamp duties, transfer fees (such as when shares are transferred).

⁴⁹ One can think of production as involving a ‘chain’ of activities ranging from conceptualizing of the product to bringing it to market. The concept of a ‘*global value chain*’ highlights not only the activities themselves and their inter-linkages, but also the value addition that occurs at each step in the production process (see, e.g., McCormick, 2007). In that context, foreign direct investment can flow into a country via what has been called *horizontal direct investment* and/or *vertical direct investment*. In horizontal foreign direct investment (*horizontal FDI*), the parent firm sets up a subsidiary/affiliate which replicates what the parent does but which is in another location/country. In the case of *vertical FDI*, the foreign subsidiary/affiliate is simply part of a value chain, and hence is engaged in only part(s) of the production process, which has been broken up by the parent firm. In fact, sometimes the affiliate is an independent firm which could even be serving more than one multinational firm or conglomerate. For the broader economics of trade and production decisions of multinationals, with regard to location of production, outsourcing, and horizontal and vertical foreign direct investment, see, e.g., Bernard, et al, 2007; Feenstra, 1998; Helpman, 2006; and Markusen, 1995.

⁵⁰ The taxes mentioned above cannot, in their total burden on the firms and the highly talented employees, be higher than those found in leading countries in the international arena. A general advice would be to look carefully at what others are doing and be as competitive as possible with respect to the types and levels of taxation.

costs with negative impact on investment and production. Legal reform along the lines discussed earlier should be pursued resolutely.

3. Macroeconomic Management

Macroeconomic policies are important for well-known reasons.⁵¹ The bottom line is that low inflation, capital mobility, stable (but legally flexible) exchange rate, and convertibility of the domestic currency or at least an absence of exchange controls, all attract investors (both local and foreign) to the local economy.

4. Financial Sector: Development and Regulatory Reform

Addressing the economic governance environment and the systemic policy fundamentals, discussed so far, will help create a favorable environment for financial system development.⁵² At the same time, the financial sector is itself an important element of the enabling environment for the other production sectors of the economy.⁵³

A developed financial system will have certain well-functioning architectural and organizational structures. This means that, from a policy point of view, financial sector development can be seen as finding a socially optimal way to put such structures in place and have them well-functioning. In this context, for most African countries, attention needs to be paid, especially, to certain important elements and aspects of the *money market*, the *payment system*, and *capital markets*. Financial sector reform also needs to address certain longstanding *access to finance* questions, particularly finance for small and medium enterprises; saving facilities for the lowest income individuals and groups; and insurance (particular micro-insurance and crop insurance, and in many countries also health and life insurance)—all of which will help raise saving and investment.⁵⁴

An important element of capacity building that is sometimes overlooked in financial sector development policies is taking steps to enhance the *financial capability of the populace at large*. Other things being equal, it seems reasonable to expect that persons with enormous financial capability, namely, “the knowledge, skills and motivation to manage their finances” (HM Treasury, 2007, p. 3), will tend to use financial systems more than persons with low capability. Indeed those with high financial capability will have greater ability to reap returns from their savings and will be willing to explore alternative ways of investing their assets and managing financial risks. Having a large proportion of the population with a high level of financial capability should motivate more business for a national financial system than otherwise, other things being equal.⁵⁵

⁵¹ Investors expect these policies to affect the real rate of return on their efforts; the expected real value of their investments in the system, over time; and the ability to transfer their assets and earnings from the domestic economy to another country.

⁵² A few African countries can also realistically strive to develop *international financial centres* within their borders, making the financial sector a major direct contributor to GDP. See, for example, Johnson (2009), for a discussion of the relevant issues, with special reference to Nigeria.

⁵³ A number of other issues are not addressed here, which would need to be covered in a comprehensive financial sector development programme [see, Johnson, 2012(2)] These include, especially, regulatory issues such as: early warning signals; compensation system and risk taking; and organizational structure—whether to be unified or not.

⁵⁴ Greater elaboration of what needs to be done in the area of financial sector reform, with special application to Sierra Leone, can be found in Johnson [2012 (2)].

⁵⁵ One can argue, of course, that the relationship between participation and/or the form of participation in the financial system on the one hand and financial capability on the other is worth empirical investigation. Policymakers can attempt empirical investigations of aspects of this big subject, in due course.

The United Kingdom, for instance, has introduced a useful initiative, elements of which can be useful as a motivation for African countries to design their own systems.⁵⁶ In African countries, typically, planning for retirement and old age has always been a challenge, abated only by the willingness and ability of the younger generation to voluntarily care for their old citizens. African countries are introducing ‘national social security and insurance trusts’ that will go some way in remedying this problem. But such programmes tend to cover mostly the formal sector, which in many countries in the continent still remains small relative to the informal sectors of the economies.⁵⁷

Regulatory reform will also be part of financial sector reform.⁵⁸ From the perspective of growth and financial sector stability, the regulatory strategy in a high-quality regulatory environment must achieve two overriding objectives. First, it must ensure clear understanding by regulators and financial firms of risks faced by the financial firms and how those risks could be managed. Second, the regulatory strategy must be clear about the role of regulation versus the market in ensuring that the financial risks are efficiently managed and controlled.

The regulatory agency or agencies of the country must ensure that the human and nonhuman capacity is there —within the regulatory community and the financial firms—to understand and manage the financial risks in the markets in which the financial firms in the country operate. The regulatory agencies must set standards and must also oversee internal processes of firms to make sure that they are appropriate and sound. Still, financial firms should take primary responsibility for their risk management. An *optimal regulatory regime and strategy*, among other things, will balance regulatory rules, supervisory review, and market discipline (see, e.g., Llewellyn, 2002).⁵⁹

A high-quality regulatory environment will also help to reduce *illicit financial flows*, by focusing on preventive measures that are effective as well as by imposing heavy punishment for crimes discovered. One reasonable way to start is to consider the fight against IFFs as an element of *corporate governance*. Already, it has become accepted that, since failures in a financial system have systemic economic effects, it is difficult

⁵⁶ The overall strategy of the British plan includes supply-side policies to improve general access to financial services markets as well as to good but affordable financial advice. The expected outcome of the strategy is “better informed, educated and more confident citizens, able to take responsibility for their financial affairs and play a more active role in the market for financial services” (HM Treasury, 2007, p. 7).

⁵⁷ Key elements of an action plan, to enhance financial capability, could include: appropriate education (mathematics, finance, etc.); improved avenues for information and advice; availability of opportunities to practice and develop appropriate skills; and outreach programmes. The central banks could lead the efforts, in partnership with the government, the financial services industry and civil society organizations of interest. Businesses and voluntary associations and organizations can, for example, offer free programmes to young people and economically disadvantaged persons.

⁵⁸ There are, at least, three major consequences of a high-quality regulatory environment for financial sector development. First, a high quality regulatory environment will have a positive effect on cooperation among the firms in the financial sector (banks, etc.) since all the firms will trust each other more than if the regulatory standards were suspect. Second, financial firms outside the country will look favorably on building relationships with the financial firms and markets in the country. Third, authorities in other countries will be less prone to imposing tight regulatory standards on dealings of their local financial firms and markets with financial firms and markets in the African country.

⁵⁹ How one determines, in practice, the balance between regulation, on the one hand, and market discipline, on the other, is bound to remain of major concern among experts. In the end, the one thing on which the experts seem to agree is that the relative weights should indeed vary from one country to another and perhaps among types and sizes of financial firms as well, depending on the particular circumstances. Some of the determining factors, for a country, would be the available expertise within financial firms and within regulatory agencies, the nature of the risks faced by the financial firms, and the relative sophistication and efficiency of the pool of others who could monitor the management of financial firms.

to be concerned with only narrow shareholder interests when looking at corporate governance of financial firms and markets in general.⁶⁰

The requirement of fiduciary duties of senior officers of financial services firms, organizations and markets should then hold the officers liable not so much for mistakes of judgment or wrong decisions but rather for actions and inactions that manifest fraud, illegality, gross negligence, and conflicts of interests or wrong decisions not made in good faith, which affect the community at large. In that work, it is not only shareholders that should take action to enforce the fiduciary rules but also the supervisory authorities. Hence, whether for risk management, financial stability, or for control of illicit financial flows, the internal supervision of financial services firms, the information reporting systems of the firms, and the decision-making processes, research facilities and standards of the organizations will all be matters of supervision/oversight by the authorities.

Thus, financial institutions can greatly help in the fight against tax evasion, capital flight, and money laundering, since a substantial proportion of illegal financial transfers will get conducted via financial institutions. Constraints on bank secrecy can thus be written in law and enforced.

Stock markets and stock brokers can also play a role. Transparency of certain investments and major transactions can be written into law, as well as the requirement to provide information to public authorities if such officials in their capacities make official requests about investors, investments, and details of certain transactions.

VI. COOPERATION

Cooperation is essential in all the specific areas and activities that affect capacity building for domestic resource mobilization. Beyond cooperation at the sectoral levels, which will, of course, occur, automatically, in conformity with normal practice, domestic cooperation at the national level is also very important. This will bring together representatives from government, business, and civil society into one cooperative structure (a sort of council) to discuss and oversee the whole package of policies. Cooperation is also important between the individual African country and the outside world.

1. Cooperation at the International Level

International organizations and governments, particularly of industrial countries, can provide African countries, directly and indirectly, with technical assistance: (1) to build capacity in certain policy areas, particularly those addressing governance matters; (2) to design specific reform policies and implementation strategies and procedures; (3) to obtain and use information and data available to the

⁶⁰ These days, most experts in the field of corporate governance start from the view that a corporation is “a complex web or ‘nexus’ of contractual relationships among the various claimants to the cash flow of the enterprise” (Macey and O’Hara, 2003). In the context of a developing country, the fiduciary duties of managers and directors of financial services firms should be broader than maximizing the value of the firm for shareholders. Loyalty of the organization’s officers to shareholders should not have external harmful effects on the larger community for which those shareholders do not pay. The beneficiaries of directors’ fiduciary duties (in particular, of care and loyalty) in the case of banks and other financial organizations should extend beyond shareholders.

international organizations and foreign countries, particularly in the fight against illegal (illicit) financial flows; (4) to have access to valuable logistics to enable successful enforcement of laws of the African countries; and (5) to enable implementation of certain conventions and international standards and codes.

As a result, for example, joint initiatives can be launched to fight money laundering, tax evasion, embezzlement of state funds, nontransparent capital flight (whether of legal or of illicit funds), and abusive transfer pricing. Such initiatives can occur at three different levels: regionally (within Africa), continentally, and internationally.

Initiatives, for example, could include putting in place important modalities to: implement international standards and codes (including peer reviews); promote financial transparency; modify rules on bank secrecy; modify laws governing trusts and corporations that permit anonymity of asset holders; punish organizations and even countries that encourage illicit financial activities and flows; establish or enhance asset recovery efforts (especially to reduce the time and expense of the procedures involved); and to fight organized crime, money laundering, abusive transfer pricing, and corruption in general.⁶¹

2. Cooperation at the National Level

Domestically, the African countries need to establish institutionalized cooperative structures at the national level—involving government, business and civil society—to address, on a continuous basis, all of the above issues discussed under governance, systemic fundamentals and cooperation at the international level. These national cooperative structures, which will be advisory in nature, will be charged with ensuring legitimate and appropriate policy design and policy implementation to achieve the desired objectives.

For instance, in the fight against tax evasion, money laundering, financing of terrorism, transfer mispricing, and smuggling, such cooperative structures will help ensure that financial institutions, nonfinancial business enterprises, regulatory agencies, border and customs officials, and other law enforcement agencies, all contribute to design of the rules and the organizational arrangements for implementation, and that the authorities are keeping systematic track of “progress” and programme implementation and reporting to the country as useful.

VII. Conclusion

This paper has addressed the challenges faced by African countries concerned with capacity building for domestic resource mobilization. It covers the nature of *domestic resources* that are to be mobilized and the nature of the *capacity for their mobilization*. It lists six binding constraints that are retarding capacity building for domestic resource mobilization followed by specification of a nine-point action plan to address those constraints.

⁶¹ The US, especially in the USA PATRIOT ACT (see, USA 2001), is a trailblazer in some of the legislation useful to fight illicit financial flows. The US Bank Secrecy Act of 1970 had already required every national bank to file a Suspicious Activity Report (SAR) when they detect certain known or suspected violations of federal law or suspicious transactions related to a money laundering activity or a violation of the Bank Secrecy Act. Large cash withdrawals can be reported in this context. Also, travelling internationally with large amounts of cash (over \$10,000) normally requires permit as well.

The institutional capacity to implement the action plan will exist, once certain **processes, rules, and organizational arrangements** are put in place. Such institutional capacity will ensure that optimal policies to carry out the action plan are designed and implementation will be as complete as necessary.

A crucial characteristic of the processes that get established will be the nature of the *cooperation* involved. This, in turn, will affect the *legitimacy* and *societal support* for the processes and hence for the rules and organizational arrangements that ultimately emerge. Elements of process include *decision-making procedures* and the *incentive structures* used to elicit cooperation—in particular, the relative roles of personal self-interest, national pride, and trust.

The **rules** will consist of the laws and regulations that address the elements of the action plan. The **organizational arrangements** will assign tasks and powers to various governmental bodies (ministries, departments, and agencies); spell out the degree and nature of political and fiscal decentralization in performing the tasks; and create national cooperation bodies (councils, committees, working groups, panels, etc.) to oversee the whole institutional process. Providing appropriate resources to do the work will also constitute an element of the organizational arrangements.

The **objective of the country**, then, should be, for each of the nine items in the action plan, to put in place processes, rules, and organizational arrangements that are legitimated by the populace at large and hence are fairly assured of appropriate societal support at the implementation stage. **Legitimation** typically entails citizens' consent (or approval) without coercion. Such consent comes via several procedures, namely, open discussion and deliberation, voting, and overwhelming demonstration of support in parliament, in the newspapers, and in civil society voluntary organizations.

African countries have become particularly concerned about illicit financial outflows out of their countries. To build capacity to combat such illicit financial flows requires: (1) building capacity to fight corruption; (2) building capacity of legal and tax authorities as well as financial firms to identify and prevent certain illegal activities associated with illicit financial flows; (3) creating incentives for individuals and businesses to keep and invest a high fraction of their profits and savings in the country, irrespective of the source of the funds; and (4) cooperating with international organizations and foreign governments, focusing on relevant incentive, regulatory and investigative mechanisms, to increase the capacity to fight illicit financial flows by getting access to information, technical assistance and logistic support, as well as launching joint initiatives to fight money laundering, tax evasion, embezzlement of state funds, nontransparent capital flight (whether of legal or of illicit funds), and abusive transfer pricing.

The finance for capacity building will come from **taxation** of domestic income, **saving** of the population, **government reallocation of expenditure**, and **foreign aid**. Success in governance and in improved economic policies should lead, simultaneously, to spikes in domestic investment, production and national income; an increase in tax revenue relative to taxable income; and a jump in the saving rate. These positive effects, perhaps small in the first few years, will lead to a virtuous circle allowing the financing and the capacity building to increase over time.

To get the process going does not require increased government expenditure, only a reallocation of that expenditure and a re-ordering of priorities. Although all the nine items of the action plan need to be addressed immediately, to get the vicious circle started promptly, particular urgency should be placed on

the first three, namely: (1) addressing corruption resolutely; (2) improving the policy environment for economic growth; and (3) stressing private sector development in economic policymaking. Once these get going, the additional tax revenue and saving will begin to be realized.

The additional foreign aid could be mainly in the form of technical assistance financed primarily by grants. Such foreign aid could come from multilateral organizations like the World Bank, the International Monetary Fund, and the African Development Bank. But bilateral aid from countries such as France, Japan, UK, and the US, as well aid from regional organizations such as the Organization for Economic Co-operation and Development, can also be useful. The authorities should decide on the nature of the aid they would like and prioritize them. They should then also decide on which aid agency/agencies they would like to approach to provide a particular type of aid.

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