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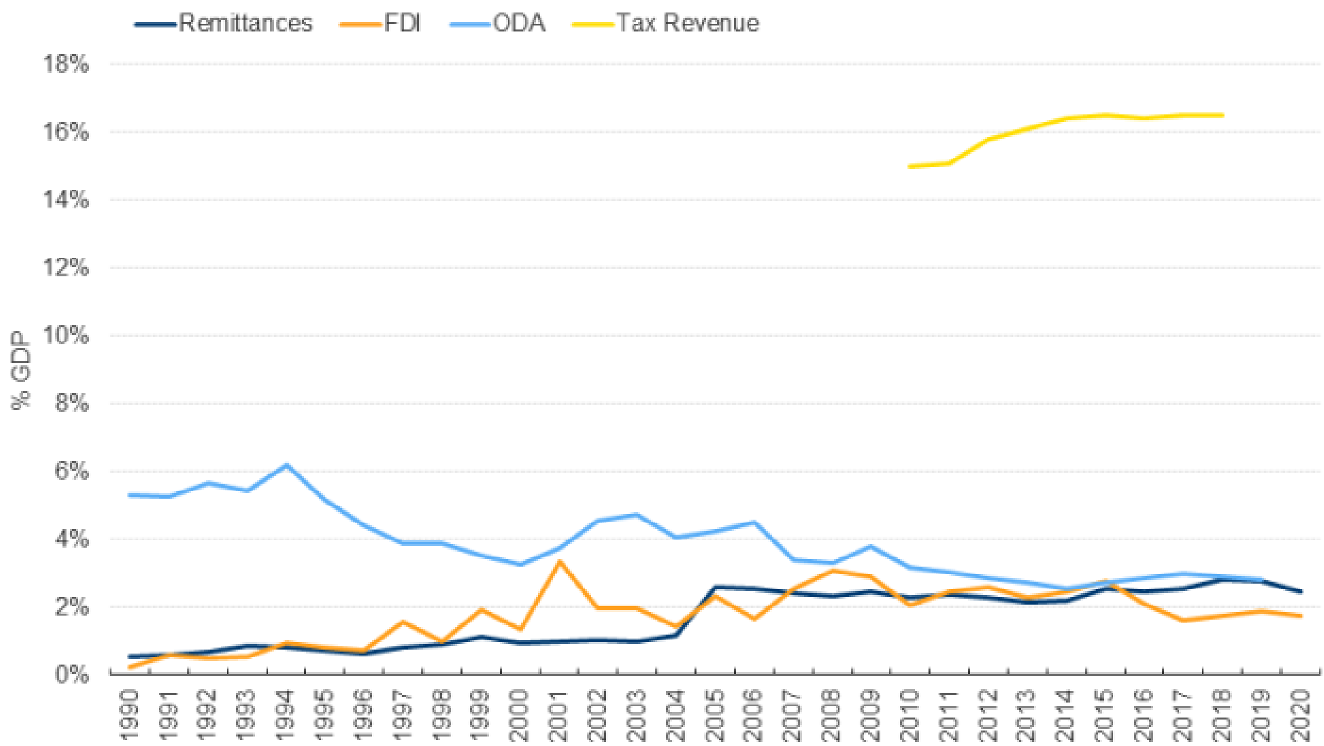
Africa in Focus

The role of fiscal decentralization in promoting effective domestic resource mobilization in Africa

Leo Holtz and Aloysius Uche Ordu Monday, August 30, 2021

The lingering economic impact of the COVID-19 pandemic is disrupting sub-Saharan Africa's traditional financial inflows, revealing the heightened need to strengthen domestic resource mobilization and improve tax administration in the region. This unprecedented shock to the world economy has revealed the volatility of financial inflows that African nations are dependent on: Indeed, foreign direct investment (FDI)—an increasingly important source of development financing traditionally rooted in oil, gas, and infrastructure projects—has declined approximately 12 percent and 25 percent in sub-Saharan and North Africa, respectively, between 2019 and 2020. Remittance inflows, which millions of African households rely on to support their families, declined by 12.5 percent throughout sub-Saharan Africa over the same period. In addition, discontent with globalization, inconsistent political environments, and competing humanitarian issues are transforming official development assistance (ODA) into an increasingly uncertain source of development financing.

Figure 1. Financial flows in sub-Saharan Africa



Source: Authors' calculations based on "GDP (current US$) – Sub-Saharan Africa," World Bank Indicators, 2021; "Keep remittances flowing to Africa," The Brookings Institution, 2021; "Phase II: COVID-19 Crisis through a Migration Lens – Migration and Development Brief 33," Global Knowledge Partnership on Migration and Development (KNOMAD), 2020; "World Investment Report 2021," United Nations Conference on Trade and Development, 2021.

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The fragility of Africa's external financial inflows to shocks in the global economy suggests African nations should focus on securing more consistent domestic revenue streams. Indeed, ensuring more effective domestic resource mobilization and tax administration systems—sources of revenue that governments have direct control over—via fiscal decentralization reforms can offer an avenue to simultaneously bolster government coffers, improve the impact of government spending, capture uncollected tax revenue spillage, and augment taxation's prominent role as a source of development financing.

Achieving better governance is easier said than done: Indeed, the experience from relatively well-executed fiscal decentralization in Brazil and Indonesia provides evidence that fiscal decentralization has the potential to improve the collection and spending of domestic tax and nontax sources of government revenue and, in addition, improve government accountability.

How can fiscal decentralization boost domestic resource mobilization?

For fiscal decentralization to be effective, countries must meet several key institutional preconditions. Meeting these institutional preconditions ensures regional/state and local/municipal governments have the capacity to institute effective decentralized expenditure allocation and revenue collection. Otherwise, fiscal decentralization has the potential to worsen public service delivery. Such preconditions include:

- Stable political environments.
- Effective autonomous subnational governments.
- Institutional capacity at regional/state and local levels of government.
- Government accountability.
- Effective democratic election infrastructure at all levels of government.
- Capacity to raise adequate levels of revenue locally.

Importantly, the potential for fiscal decentralization to benefit domestic resource mobilization stems from improvements in public service delivery, particularly in terms of allocative efficiency, preference matching, and stronger government accountability.

Local governments benefit from an informational advantage, whereby their proximity allows them to better understand the needs and preference of their local constituents. Relative to the central government, this informational advantage enables local governments to more effectively allocate public resources and serve needs of the people.

Local governments' geographic proximity to their constituents—the direct beneficiaries of public services—also pressures local authorities to efficiently allocate fiscal resources. This productive efficiency of local public service delivery promotes government accountability through the direct election of local officials by the local populace, which also empowers voters with control over their public authorities and institutions. The subsequent performance of neighboring localities also provides local voters with a model to compare the competencies and effectiveness of their local politicians, as well as encourages competition among local governments to produce effective public services.

Drawbacks of fiscal decentralization

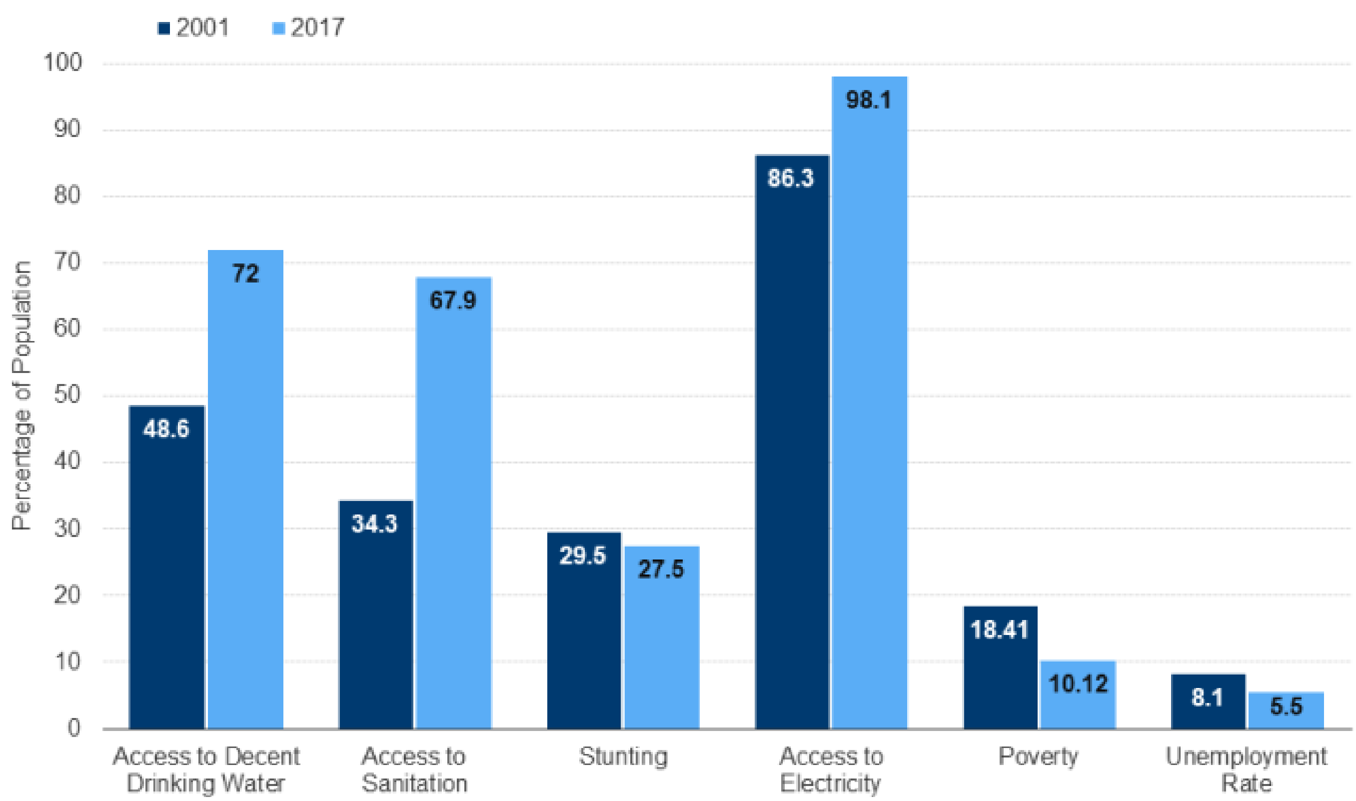
While fiscal decentralization provides an alternative fiscal structure to improve the collection and spending of government revenue, drawbacks exist. Hierarchical fragmentation of government services can impose the loss of economies of scale and, therefore, cause decreased efficiency and higher costs in the production, implementation, and distribution of public goods and services. Fiscal decentralization, which reduces federal government revenue, may also weaken the central government and hinder its full capability to redistribute national resources from regions/states with surpluses to localities in need of funding. Furthermore, without the infrastructure to support legitimate democratic local elections, fiscal decentralization will not improve government accountability and may introduce incentives for rent-seeking political behavior and the misallocation of local resources to nonproductive expenditures. In what follows, we compare the experiences of Brazil, Indonesia, and Nigeria—three economic powerhouses in their respective regions.

Evidence from Indonesia

Following economic and financial crises, Indonesia transitioned to a decentralized governmental system in 1999. Regional governments became empowered to manage governmental and public services, with notable exceptions in the regulation of religion, defense, national security, and monetary policy. Indonesia's fiscal structure enables provinces and municipalities to collect local taxes and set local tax rates according to their budgetary needs, while maintaining a fiscal network between the subnational and federal government to ensure an equitable budgetary balance across provinces. These transfer payments alleviate horizontal, cross-state fiscal imbalances and promote equitable distribution of state revenue.

Since the implementation of fiscal decentralization in Indonesia, social welfare, public service delivery, and a myriad of development indicators have improved significantly.

Figure 2. Indonesia's public service and social welfare progression



Source: "Fiscal Decentralization: Indonesia's Experience," Ministry of Finance - The Republic of Indonesia, 2019.

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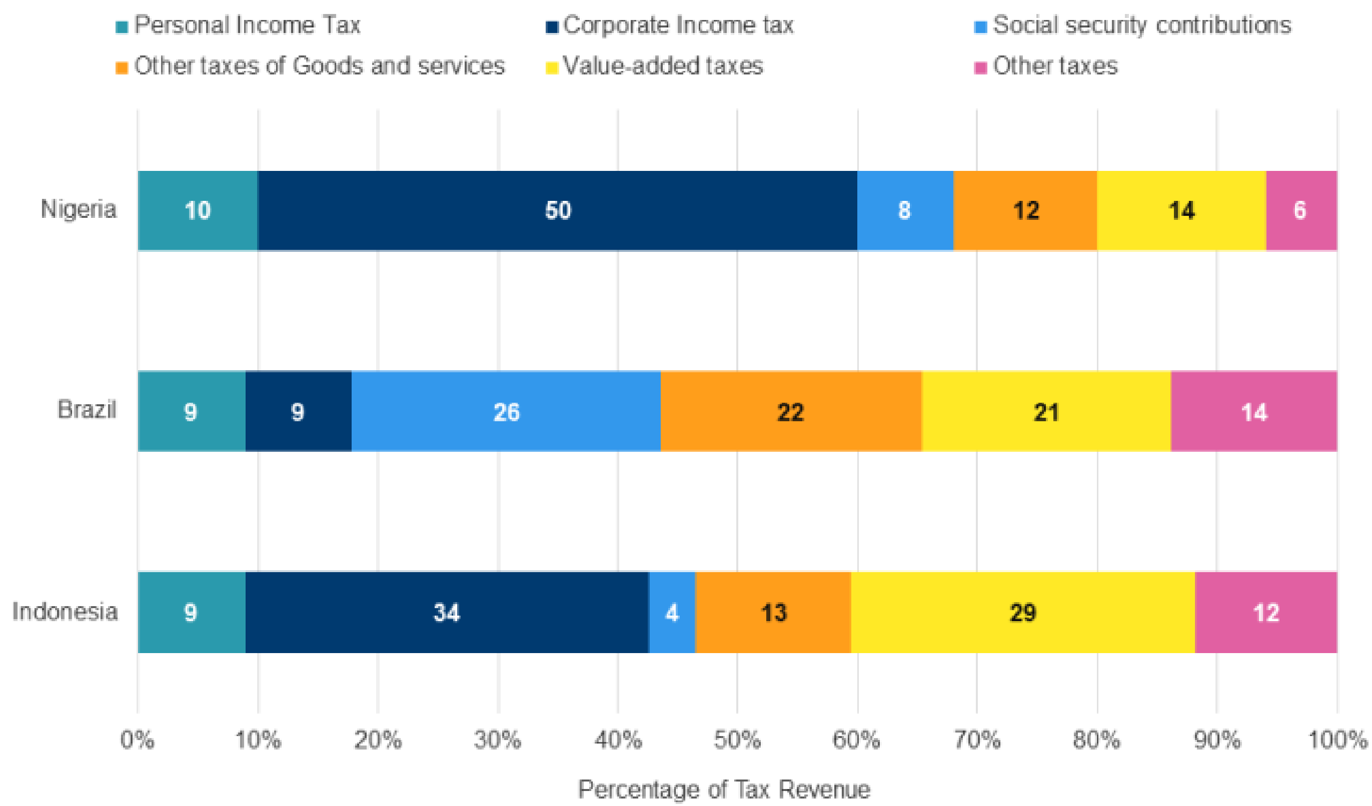
Evidence from Brazil

Brazil's model of fiscal decentralization offers an insight into the importance of intergovernmental tax transfers to prevent revenue imbalances among states. The redistributive structure of the Brazilian federal fiscal system allows poorer states to access a greater share of revenue from federal transfers than wealthier states, which enjoy a more substantive tax base. In turn, these wealthier states also benefit from greater budgetary autonomy. As a result of the integration of intergovernmental transfers mediated by the federal government, Brazil's equitable revenue transfer system allows it to maintain low levels of vertical imbalances—the differences between budgetary mandates and revenue assignments throughout all levels of government—relative to the international average and select wealthy countries such as United Kingdom, Spain, and Australia.

Evidence from Nigeria

Nigeria's model of fiscal decentralization has persisted since 1946, but its decentralized system of revenue allocation and collection has not manifested in notable improvements to the country's nominal tax revenue or tax-to-GDP ratio over the years. While some of Nigeria's revenue collection inefficiencies may be tied to its relatively high rate of tax evasion and avoidance, the bureaucratic, administrative, and institutional requirements at the local level of government may be limiting the proper implementation and delivery of decentralized public services. Studies, however, have uncovered positive relationships between fiscal decentralization and social and health outcomes in Nigeria, such as higher literacy rates and lower infant mortality rates.

Figure 3. Comparative decentralized tax revenue structure



Source: Authors' calculations based on "Revenue Statistics in Latin America and the Caribbean 2021 – Brazil," Organization for Economic Co-operation and Development (OECD), 2020; "Revenue Statistics in Asian and Pacific Economies 2020 – Indonesia," and OECD, 2020; "Revenue Statistics in Africa 2020 – Nigeria," OECD, 2020.

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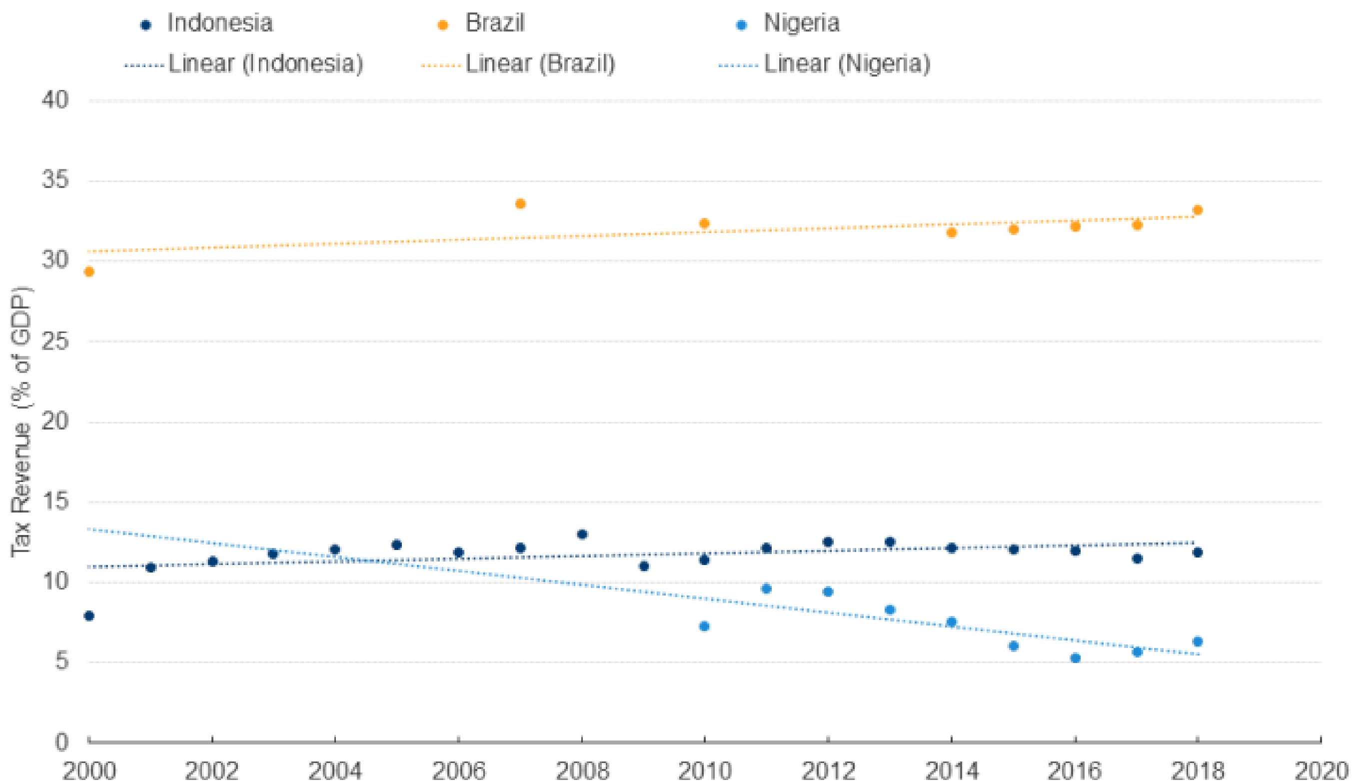
Figure 4. Tax-to-GDP ratio



Source: Authors' calculations based on "Revenue Statistics in Latin America and the Caribbean 2021 – Brazil," Organization for Economic Co-operation and Development (OECD), 2020; "Revenue Statistics in Asian and Pacific Economies 2020 — Indonesia," and OECD, 2020; "Revenue Statistics in Africa 2020 — Nigeria," OECD, 2020.

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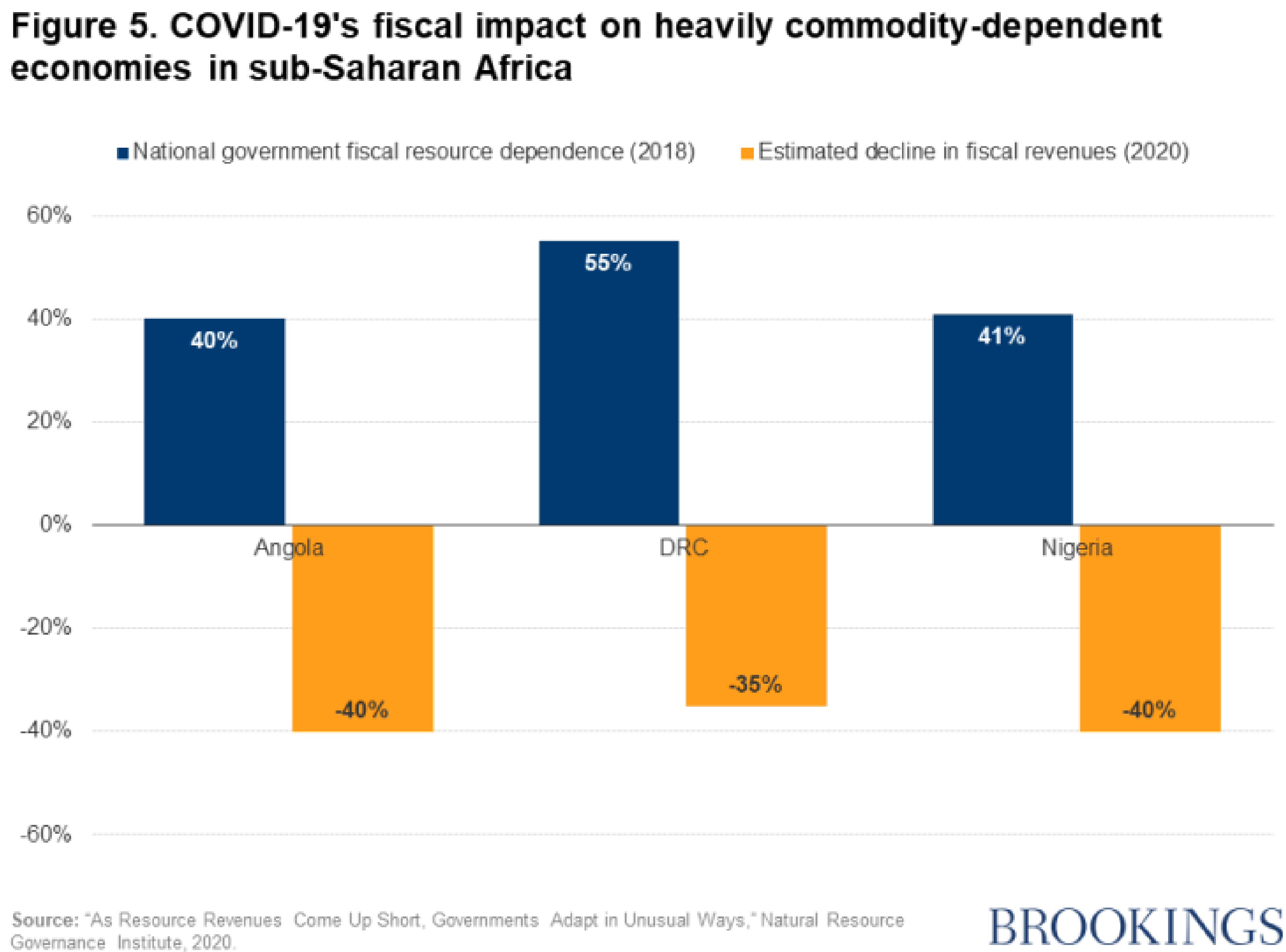
Can effective fiscal decentralization improve domestic resource mobilization?

The successful implementation and outcomes of fiscal decentralization in Brazil and Indonesia offer insight into decentralization's ability to improve public service delivery, increase government accountability, and promote social, economic, and human development goals. Yet, the institutional preconditions throughout all levels of government that are necessary for successful implementation of fiscal decentralization suggest the reform is not always fully successful, as seen in Nigeria. Nonetheless, the potential for fiscal decentralization to improve public service delivery, efficiency, and accountability remains an attractive alternative governmental system, as Kenya became the most recent African nation to successfully institute a decentralized fiscal system following the approval of its new constitution in 2010.

Lessons for Africa

Shoring up and capturing the full potential of domestic taxation is one of the most important sources of development financing and therefore needs to be a policy priority for African governments. The ability of domestic resource mobilization to provide a hedge against fluctuations in the global economy and volatile commodity prices is especially important for resource-rich countries whose fiscal systems are heavily commodity dependent.

Because 46 African countries and 89 percent of sub-Saharan Africa are commodity-dependent economies (as categorized by the U.N.), African fiscal systems maintain significant exposure to international commodity markets and the global economy. The COVID-19 pandemic exposed this vulnerability, as large commodity-dependent economies with a hefty fiscal reliance on commodity exports, such as Angola, Nigeria, and the Democratic Republic of the Congo, experienced precipitous declines in government revenues in 2020. As a result, these countries were forced to respond with spending cuts, debt issuance, and support from international financial institutions, alongside heightened budgetary requirements, to tackle the pandemic and its economic fallout.



Considering the deleterious impact of the pandemic on African finances, restructuring fiscal dependence away from financial inflows and toward domestic tax resources will provide a route to greater fiscal self-reliance and economic stability. In turn, bolstering internal revenue streams and downstream fiscal stability will make African economies more attractive to international investors—who simultaneously see the continent's enormous growth potential but remain apprehensive about its economic and political risks.