**COMESA MONETARY INSTITUTE**

# ENHANCING THE EFFECTIVENESS OF FISCAL POLICY FOR DOMESTIC RESOURCE MOBILIZATION IN THE COMESA REGION

**Prepared by:**

**Ibrahim A. Zeidy, Director, COMESA Monetary Institute**
**Dr. Lucas Njoroge, Senior Economist, COMESA Monetary Institute**

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**TABLE OF CONTENTS** **Page**


**I. Introduction** 1

**II. The role of fiscal policy in economic development** 2

a) Mobilisation of domestic resources 2
b) Resource allocation to achieve accelerated growth 2
c) Reduce inequality by investing in human capital 2
d) Increasing employment opportunities 2
e) Macroeconomic stabilization 3

**III. Challenges to fiscal policy implementation** 4

**IV. Fiscal performance of member States** 4

a) Expenditures and revenues 4
b) Current balance 8
c) Overall budget balance 9
d) Primary balance 10
e) Financing 11
f) Public debt 12

**V. Recent fiscal and structural reforms in member countries** 13

a) Privatisation and liquidation of public enterprises 14
b) Tax reforms and tax administration 14
c) Public finance management reforms and preparations of MTFF 17

**VI. Recommendations for enhancing domestic resource mobilisation** 19

a) Public resource mobilization 19
b) Developing private sector resource mobilisation 23
c) Other sources of resource mobilisation 24
d) Resource mobilisation to enhance regional integration 25

**VII. Summary and conclusions** 25

**Annex 1** 28

**References** 30

## LIST OF ACRONYMS

CAADP (Comprehensive Africa Agriculture Development Programme)
COMESA (Common Market for Eastern and Southern Africa)
COSWAP (COMESA SWAP)
EITI (Extractive Industries Transparency Initiative)
ESP (Excessive Slippages Procedure)
GDP (Gross Domestic Product)
IGT (Identifiable Grouping Taxation)
IMF (International Monetary Fund)
MDG's (Millennium Development Goals)
MFSF (Multilateral Fiscal Surveillance Framework)
MTBF (Medium Term Budget Framework)
MTCCP (Medium Term Country Convergence Programme)
MTFF (Medium Term Financial Framework)
ODA (Official Development Assistance)
OECD (Organisation for Economic Co-operation and Development)
PEFA (Public Expenditure and Financial Accountability)
PFM (Public Finance Management)
PPP (Public-Private Partnerships)
SACU (South African Custom Union)
SDR (Special Drawing Rights)

**Enhancing the Effectiveness of Fiscal Policy for Domestic Resource Mobilization in COMESA Region**

## *I. Introduction*

1. One of the key lessons from the Euro debt crisis of 2011 has been the importance of long-term fiscal sustainability in economic development. The crisis in Greece and Spain was largely attributed to fiscal indiscipline over a long period of time. Recent trends in fiscal performance of most countries in the COMESA region demonstrate shrinking fiscal space as revenue mobilization has been slow compared with the fast increasing spending growth. For most COMESA member countries there is a wide gap between total investment needs and domestic resource mobilization. In order to achieve sustained growth, COMESA member countries are therefore, expected to pursue prudent fiscal policies supported by increased domestic resource mobilisation in order to ensure faster pace of monetary integration which will culminate in monetary union.

2. The justification for prescribing prudent fiscal policy to enhance regional integration is that they ensure the viability and sustainability of the monetary integration programme, by ensuring that a member state does not out pace other members in terms of larger budget deficit and inflation rates. Prudent fiscal policies also protect member countries from being exposed to contagion effects of macroeconomic instability in one or more member countries. It also contributes for effective domestic resource mobilization for increased investment.

3. In order to achieve fiscal prudence in member countries, the COMESA Summit adopted in 2012 the COMESA Multilateral Fiscal Surveillance Framework. (See annex 1 for detailed discussions of the elements of the Framework). The Surveillance process is based on countries developing national convergence programmes that will be the subject of the Multilateral Fiscal Surveillance Mechanism.

4. The purpose of this paper is to consider the relationship between fiscal policy and domestic resource mobilization in the COMESA region. The overall goal of the paper is to present alternatives for increasing the mobilization of resources to accelerate growth and facilitate poverty reduction. Section 1 of the paper briefly treats the role of fiscal policy for economic development. Section 2 discusses major challenges faced by member countries in fiscal policy implementation Section 3 discusses fiscal performance of member countries. Section 4 elaborates on recent fiscal and structural reforms in member countries. Section 5 discusses recommendations to enhance domestic resource mobilization. Finally, summary and conclusions will be provided.

## *II. The role of fiscal policy in economic development*

5. The role of fiscal policy in developed economies is to maintain full employment and stabilize growth. In contrast, in developing countries, fiscal policy is used to create an environment for rapid economic growth. The various roles fiscal policy plays in this regard are the following:

(a) **Mobilisation of domestic resources**: Developing economies are characterized by low levels of income and investment, which are linked in a vicious circle. This can be successfully broken by mobilizing domestic resources for investment energetically. Fiscal policy can play an important role in enhancing domestic resource mobilisation

(b) **Resource allocation to achieve accelerated growth**: Fiscal policy entails use of government expenditure and tax policies to boost efficiency and improve long term economic performance by dealing with critical market failures. For instance, government provisions of infrastructure, research and development, or education among other public goods which the private sector itself is unable to provide in optimal quantity or quality because of market failures, are good examples. However, benefits of a change in public expenditure need to be weighed against how the expenditure is financed. Most taxes generate distortions and efficiency costs while public borrowing and growing debt affect growth. The government has not only to mobilize more resources for investment, but also to direct the resources to those channels where the yield is higher and the goods produced are socially acceptable.

(c) **Reduce inequality by investing in human capital**: This will be done by increased spending on education and health. Spending that improves the quality of health and education services at all levels will endow the population with the necessary tools to take advantage of opportunities and thus reduce inequality. It is therefore, imperative that budgets provide adequate resources to build the human resources for the future, including improving school infrastructure, educational materials and equipment, clinics, and hospitals. Inequality can also be reduced by explicit policies to enhance social protection, food security and nutrition; as well as development of low income housing.

(d) **Increasing employment opportunities**: Fiscal incentives, in the form of tax-rebates and concessions, can be used to promote the growth of those industries that have high employment generation potential. Moreover public investment (including PPPs) on infrastructure such as transport, logistics, energy, water resource development, schools, hospitals will help create employment directly in the formulation and construction of projects, the production of inputs for the projects, and the operation and maintenance of new facilities. Public investment

also crowds in private investment and so would create employment indirectly by improving the efficiency of the economy and laying the basis for faster growth.

(e) **Macroeconomic stabilization**: This entails using countercyclical fiscal policy in the short run to offset the impact of macroeconomic shocks that create large or persistent gaps between aggregate demand and potential output, thereby helping to avert both excessive cyclical unemployment and inflationary pressure. In the long run, macroeconomic stabilization entails keeping fiscal deficits and public debt on a sustainable path, so that public finances do not themselves become source of macroeconomic instability.

6. The ability to perform the above mentioned role of fiscal policy depends particularly on domestic capacity to mobilise resource especially public revenue. Effective mobilization of domestic resources can generate the following benefits among others:

(i) Taxation, which is the major component of domestic resources for most countries in the region, is generally associated with more efficient resource use, accountability and greater public participation required for the success of development process.
(ii) Relying on domestic resources negates the effects of Dutch disease commonly associated with external inflows, and reduces the vulnerability to speculative attacks on currencies or even financial crisis.
(iii) Domestic resources brings about a sense of patriotism and ownership of development policies and outcomes unlike foreign aid that comes with conditionalities, constraining a country's ability to maneuver and adopt policies that are consistent with its national development goals. That is, domestic resources give governments' the latitude required to use fiscal policy to achieve their development objectives.
(iv) Domestic resources are predictable, less volatile and stable than external finance. Reliance particularly on foreign aid is facing serious head winds including donor fatigue, many unmet conditionalities, mismatch between pledges and actual disbursements, and changing motives by donors which make access to aid more difficulty. Falling foreign aid resources and volatility of commodity prices have only made the situation worse, calling for renewed efforts to accelerate mobilization of domestic resources as well as for reforms to increase spending efficiency.

7. However, the benefits of domestic resource mobilisation only accrue to countries that make deliberate efforts to exploit the existing opportunities especially since resource mobilization is not a costless activity and its effectiveness depends on whether governments have the political will and capacity to create a conducive environment as well as put in place the appropriate policy measures. The important role of fiscal policy

in domestic resource mobilization emanates from its effect on the capacity of government to increase domestic revenue through various taxes and expenditure policy measures and how such measures in turn affects households and firms incentive to save and work. Mobilizing domestic resources is therefore, an expensive affair and requires concerted efforts from individuals, firms and governments.

## *III. Challenges to Fiscal Policy Implementation*

8. The following are some of the challenges for fiscal policy implementation in COMESA member countries:

(i) Low level of private savings. This is partly because of a large informal sector, where transactions do not pass through the formal banking system; low incomes due to the high level of poverty; and inadequate incentives for people earning low incomes to use formal banking services.
(ii) A sizeable portion of most economies in COMESA is non-monetized, rendering fiscal measures of the government ineffective and self-defeating.
(iii) Lack of statistical information as regards the income, expenditure, savings, investment, employment etc. This makes it difficult for the public authorities to formulate a rational and effective fiscal policy.
(iv) Fiscal policy cannot succeed unless people understand its implications and cooperate with the government in its implication. This is due to the fact that, in developing countries, a majority of the people are illiterate.
(v) Large-scale tax evasion, by people who are not conscious of their roles in development, has an impact on fiscal policy.
(vi) Fiscal policy requires efficient administrative machinery to be successful. Most developing economies have corrupt and inefficient administrations that fail to implement the requisite measures vis-à-vis the implementation of fiscal policy.
(vii) Private capital flows especially in form of foreign direct investments have not had a noticeable impact in filling the resource gap since many countries in the region have not been very attractive to such flows although the trend is now changing. Political instability, security, infrastructure deficit and low incomes are some of the main hindrance to foreign direct investments.

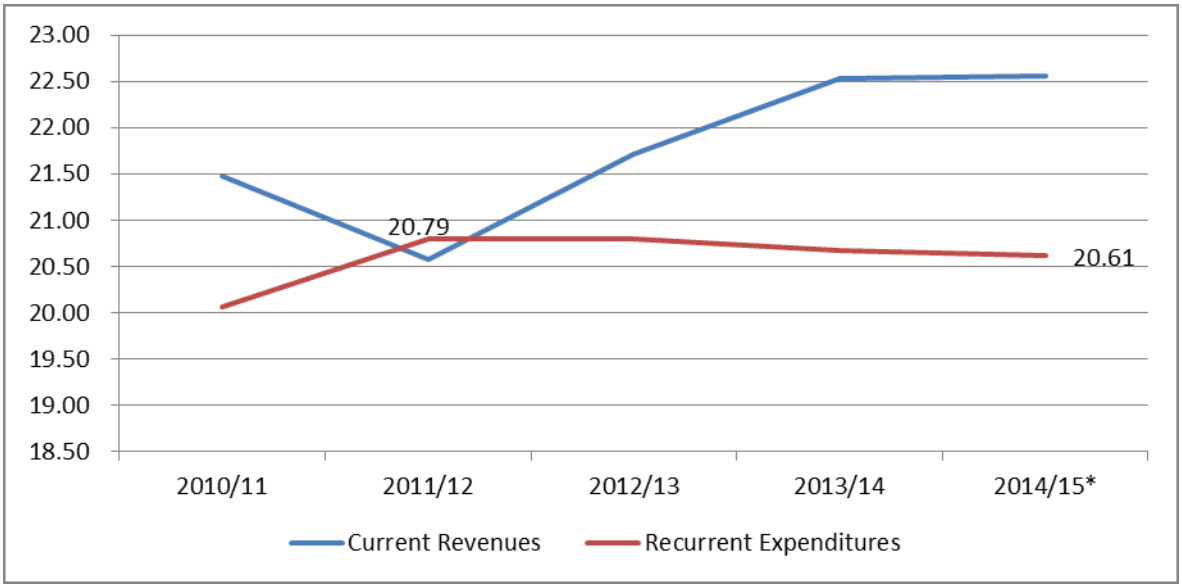
## *IV. Fiscal performance of member countries*

### a) Expenditures and Revenues

9. Starting from 2010/11, many countries in the region increased recurrent expenditure despite weaker fiscal revenues (figure 1). However, since then, current revenues have been increasing for the region as a whole. Recurrent expenditure however remained fairly constant over the entire period except for the period 2010/11 to 2011/12 when the recurrent expenditures were on the rise. The increase in recurrent expenditure for the period reflected increased war related expenditures in some countries that experienced political turmoil over the period. Managing political situation

and exercising budget discipline while maintaining macroeconomic stability remain a priority for these countries.

**Figure 1: Recurrent expenditures and current Revenues** *(in percent of GDP[1])*




*Source: Based on IMF Staff Reports Data*

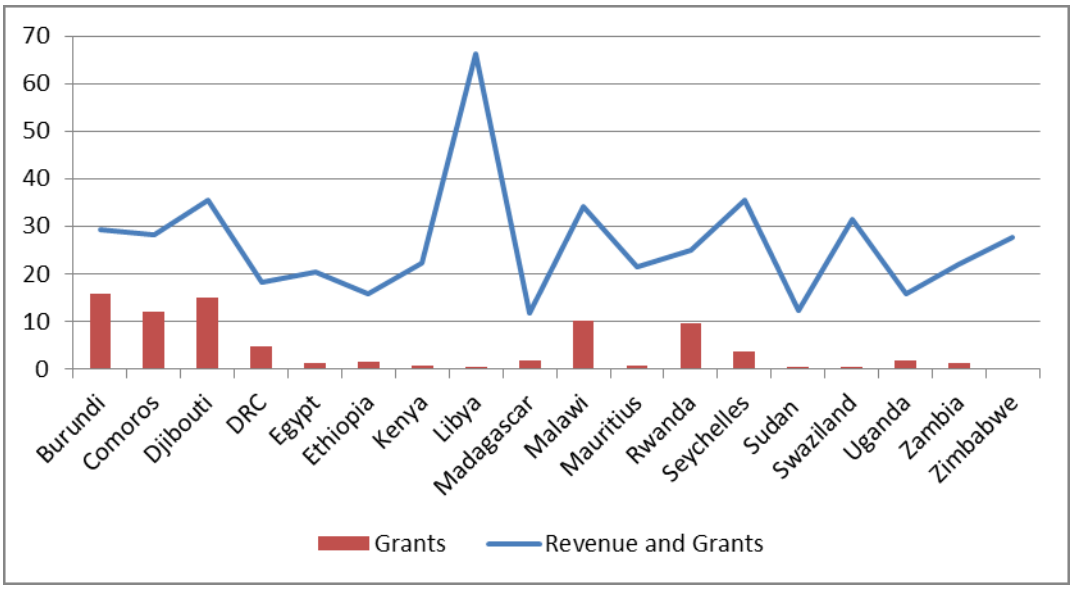
10. The fairly constant recurrent expenditures from 2011/12 to date indicate the challenge of reducing recurrent expenditures. The pressure from growing populations in the region places high demand for health, education, maintenance of infrastructures and delivery of other public services with direct implication of increasing recurrent expenditures. Structural measures designed to curtail the growth of the civil service and weed out areas of inefficiency are difficult to implement and take time to have effect. Powerful lobbies with vested interests normally make it even harder for the government to scale down its size.

11. The trend in current revenues and recurrent expenditure depicts the nature of fiscal policy in the region with evidence of its pro-cyclical nature depending on the structure of economies and macroeconomic policy regime in individual countries. In other words, fiscal policy is expansionary during booms while during depressions fiscal policy is contractionary (Thorton, 2008). The main reasons for the procyclical nature of fiscal policy in most COMESA economies include; first, the limited fiscal space due to conditions attached to external resources which limit policy choices available to respond to shocks. Second, the availability of financing is pro-cyclical for most of these countries since in good times countries are able to borrow and in bad times there is limited access to finance, limiting the ability to use counter-cyclical fiscal policies. Third, some

[1] Data used in this study is based International Monetary Fund country reports over the period 2010/11 to 2014/2015.

countries have implemented fiscal rules aimed at ensuring fiscal sustainability which make it difficult to pursue counter cyclical fiscal policies to off-set the impact of shocks. Finally, political economy issues may prevent a government to pursue counter-cyclical fiscal policy as it is forced to give in to pressure from various powerful lobbies, making it difficult to moderate spending during booms (Delong and Summers, 2012).

**Figure 2: Revenues** *(in percent of GDP)* (2010/11 to 2014/2015)[2]




*Source: Based on IMF Staff Reports Data*

12. Total Revenues and grants as a percent of GDP for the region average 26 percent of GDP (figure 2). High revenues in some countries reflected the contribution of oil revenues to total revenues. Grants for the region averaged 4 percent of GDP.

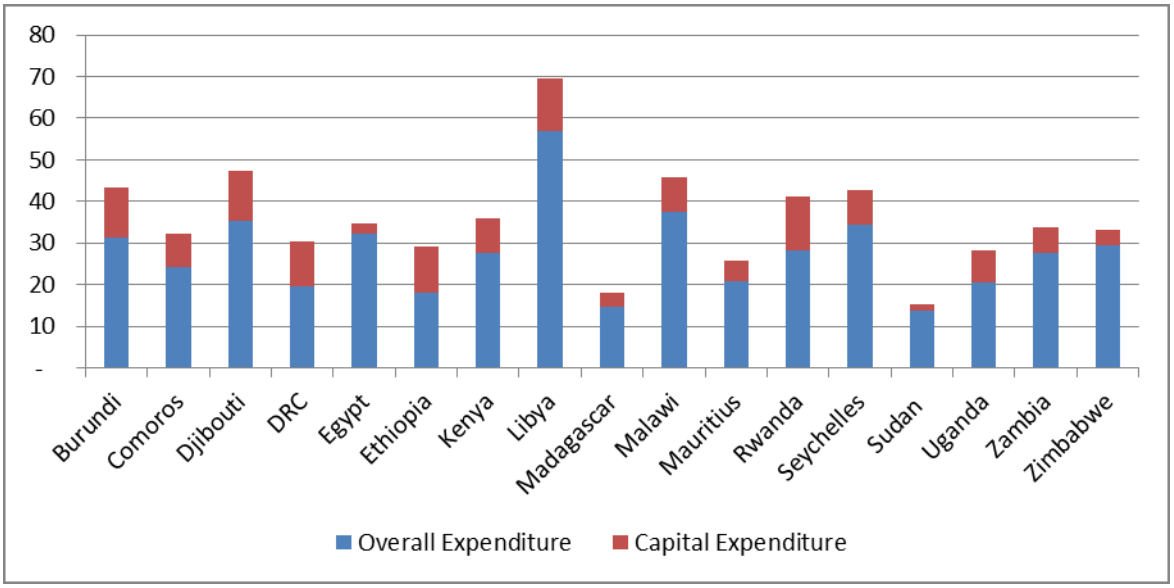
13. The overall expenditure in percent of GDP for the region averaged 28 percent of GDP for period 2010/11 to 2014/15. Capital expenditure to GDP ratio averaged 8 percent for the region (figure 3). In some countries where capital expenditures were unusually high, spending was in line with the objective of enhancing fixed capital formation in productive areas and was attained through weeding out unproductive investments. By contrast, in some other countries, civil strife resulted in inflated military expenditure through purchase of military hardware over the review period.

14. Despite the objective of promoting growth through higher productive investments, most member countries had modest capital expenditures attributed to among others, the following reasons. First, some countries rely on donor funds for capital expenditure

[2] Data for Sudan exclude South Sudan after July 2011 onwards.

which require satisfying some conditionalities before disbursements, leading to delays or shortfalls in capital expenditures. Second, bureaucratic and administrative delays in recipient countries may also cause capital expenditure delays. Third, lack of government funds to finance the domestic portion of the costs and delays in release by different donors also lead to capital expenditure shortfalls in a number of countries. Finally, governments find it easier to meet the overall budget targets by reducing capital expenditure than cutting wages and salaries or raising taxes.

**Figure 3: Overall Expenditures** (2010/11 to 2014/15) *(in percent of GDP)*




*Source: Based on IMF Staff Reports Data*

15. It is therefore important to reduce budget deficit by increasing revenue and decreasing unproductive expenditure in real terms. Equally important is ensuring that revenues are obtained more efficiently and equitably with least distortion on prices and price incentives. Expenditures composition should change so that the public capital stock expands in productive areas and is better maintained, reduce military and other relatively unproductive expenditures, and enhance social welfare through increased spending in health, education and other measures to alleviate poverty.

16. The pattern of overall expenditure in the region indicate that the effectiveness of fiscal programs including efficiency with which revenues are raised, the cost-effectiveness of public service delivery, or how well public resources are protected from corruption and waste depend on the quality of public financial management institutions in a country. In some countries, the costs of government failure may have exceeded the cost of market failures the government as an institution intended to address. Political

economy factors and institutional capacity ultimately affect a country's ability to actually implement sound fiscal policies.

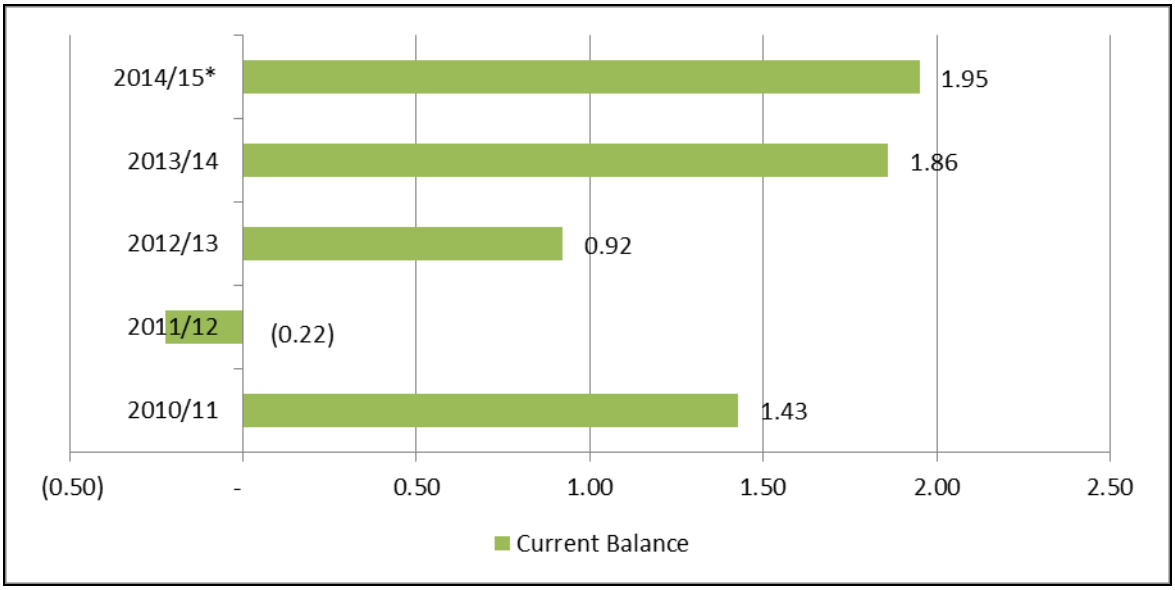
17. Although overall expenditures seems to be in line with revenues at the regional level, at the country level it seems that in many countries revenue mobilization has not kept pace with rising public spending due to among others the pressure to increase social spending in order to protect the vulnerable groups.

**b) Current balance** (in percent of GDP)

18. Current balance being the difference between current revenues (excluding grants) and recurrent expenditures helps to gauge government's contribution to public sector savings[3]. Figure 2 indicates that on average the economies of the region set aside a significant proportion of their resources to support public investment. For all the COMESA member countries on average, the current balance has improved from a deficit of 0.2 percent of GDP in 2011/12 to a surplus of 1.86 percent of GDP in 2013/2014 and is projected to improve further to an average of 1.95 percent of GDP in the current fiscal year 2014/2015. However, developments in the current balance were mixed for individual member country. Improved tax collection and better public finance administration through new Public Finance Management (PFM) frameworks in a number of countries explains the improvement in current balance for a majority of countries in the region. Specifically, all the countries in the region experienced improvement in current balance on average over the period under review except a few which experienced deterioration. Egypt performance was affected by the Arab Spring while Sudan current balance was affected by the separation with South Sudan. Swaziland current balance reflects the increased significance of revenues from South African Custom Union (SACU) against new fiscal discipline challenges.

[3] This is based on the assumption that none of the capital expenditure items fall under recurrent expenditures.

**Figure 2: Current Balance** *(in percent of GDP)*



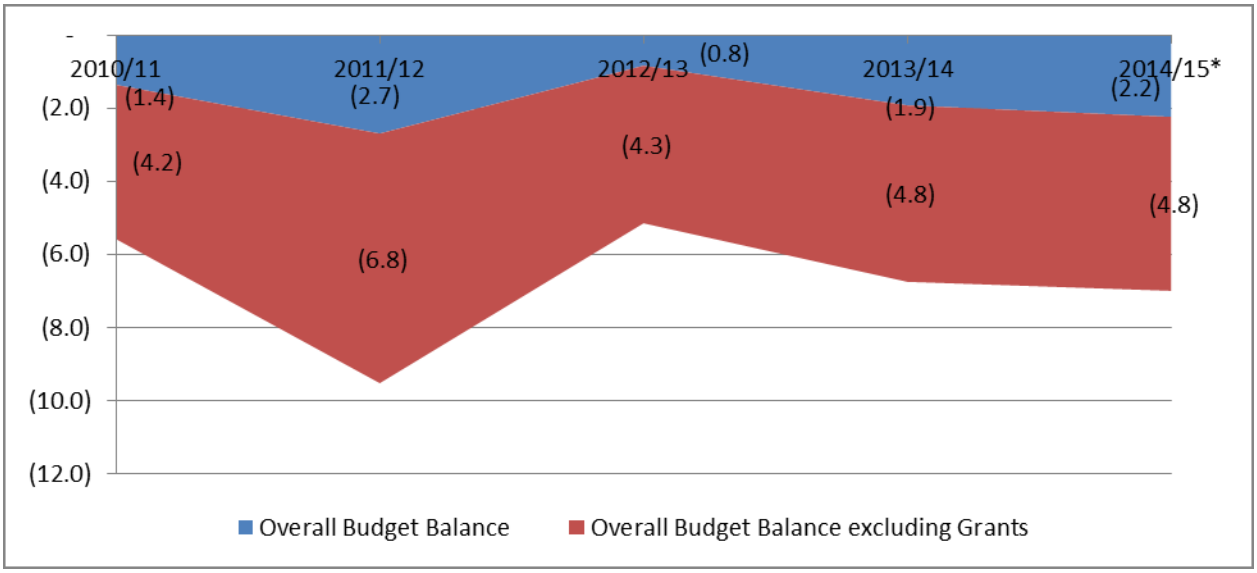

*Source: Based on IMF Staff Reports Data*

### c) **Overall Budget Balance (**in percent of GDP**)**

19. The overall budget deficit excluding and including grants deteriorated for most of the period except between 2011/12 and 2012/2013. The worsening in the overall budget deficit reflects higher overall expenditures that have outpaced the growth in overall revenues for most countries in the region. The overall budget deficit including grants averaged 1.8 percent compared to the average overall budget deficit excluding grants of 5 percent for the entire region reflecting the importance of grants to a number of the countries.

20. The performance of the overall budget balance is in sharp contrast to the performance of the current balance indicating the regions greater reliance on increasing capital expenditure to attain overall fiscal objectives. Capital expenditure for the region averaged 8 percent of GDP.

**Figure 3: Overall Budget Balance including and excluding grants** *(in percent of GDP)*

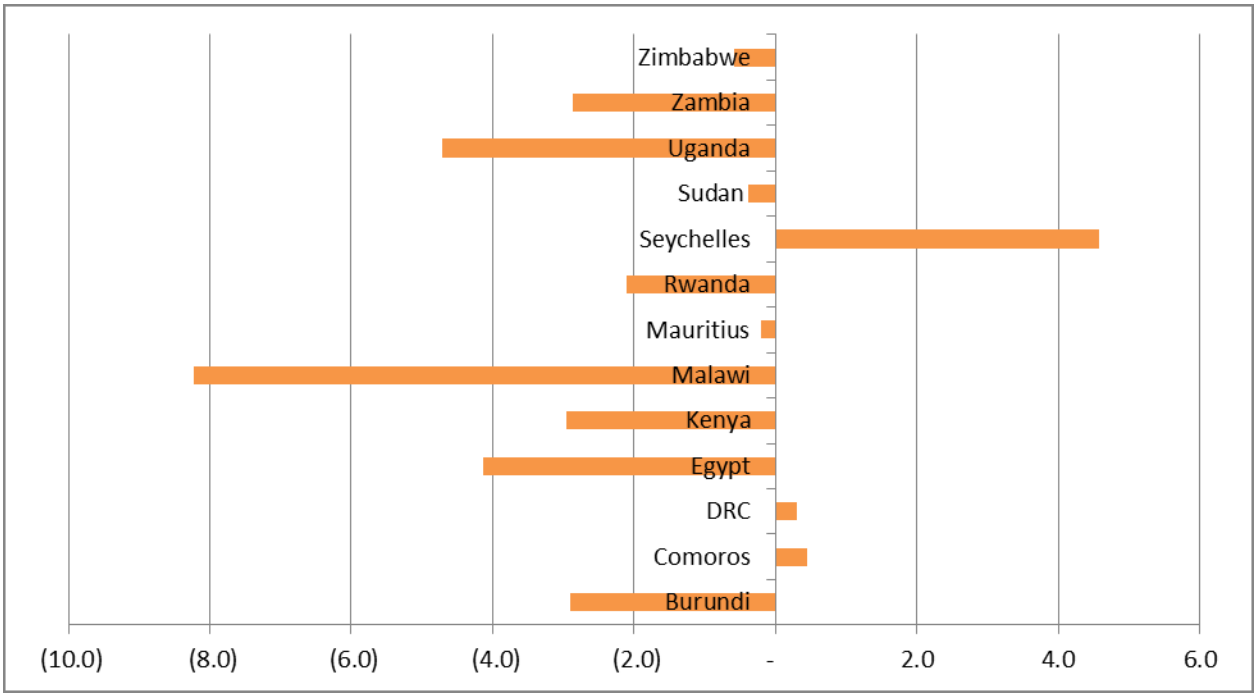



*Source: Based on IMF Staff Reports Data*

### d) Primary Balance

21. Debt service obligations remain a challenge for a number of COMESA member countries. In this regard, the main concern for these countries is the primary balance, that is, the overall balance excluding interest payment. For the entire period, the primary balance averaged at -1.8 percent for the region (figure 4). This suggests that for some countries interest payments constitute a significant proportion of the overall expenditure due to overreliance on external assistance.

**Figure 4: Primary Balance** *(in percent of GDP)*

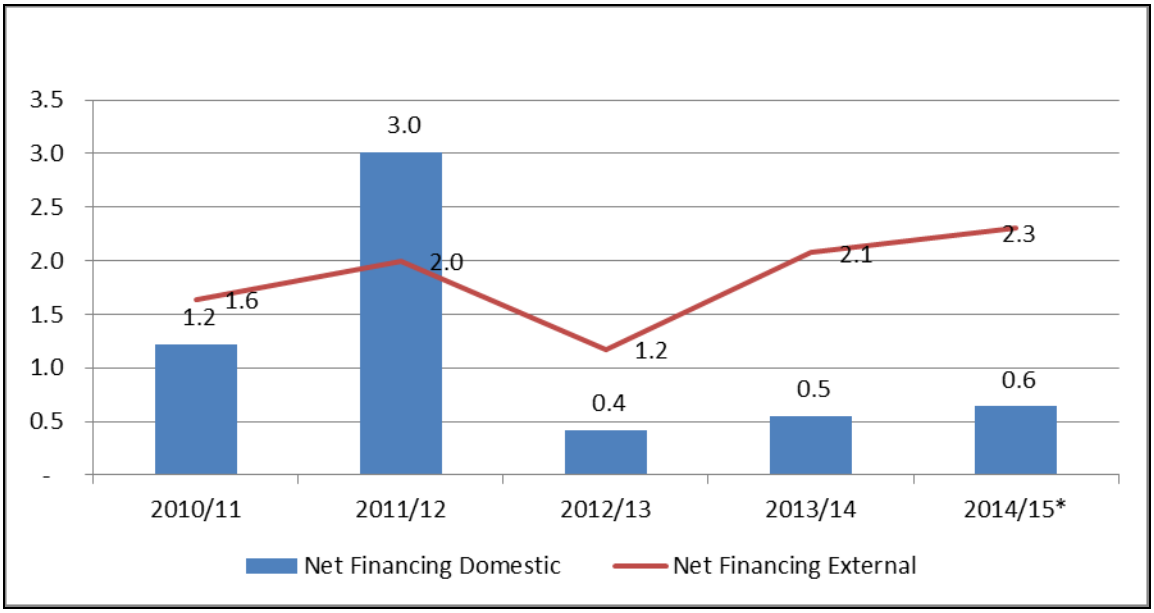



*Source: Based on IMF Staff Reports Data*

### e) Financing

22. The proportion of the deficit financed through foreign sources averaged 1.8 percent of GDP, suggesting that the flow of foreign resources to the region increased over the period under consideration except for a few cases. As earlier alluded to, the increase in external financing is not matched by an increase in public capital formation for a number of countries but help sustain necessary recurrent expenditure except in a few cases.

**Figure 7: Financing** *(in percent of GDP)*



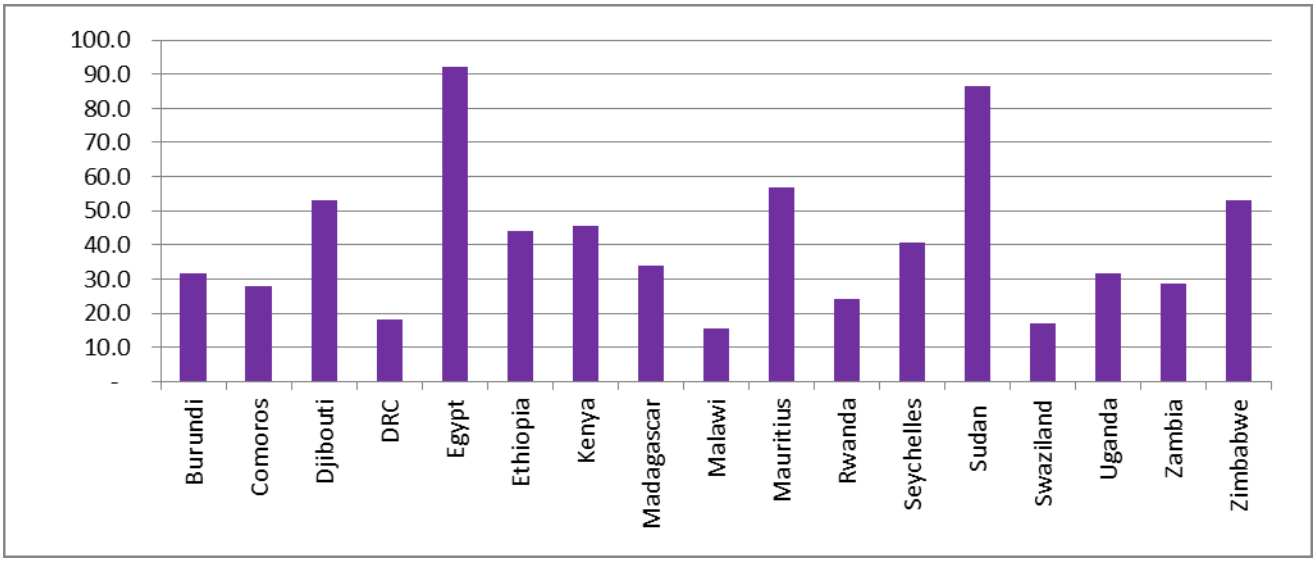

*Source: Based on IMF Staff Reports Data*

23. The financing of the deficit through domestic sources for the region averaged 1.2 percent of GDP. Except for a few outliers, the average net financing from domestic sources (mostly domestic bank borrowing) remained low due to prudent macroeconomic management under the IMF supported programmes that emphasizes low and stable inflation. Many member countries have tended to rely on other sources of financing including sovereign bond issuance, commercial (syndicated loans) and foreign concessional borrowing that are less inflationary. However, excessive reliance on these other sources could be counterproductive as it may crowd out the private sector from access to savings and also impose an additional interest burden so that the government must bid up interest rates to attract a greater amount of private savings.

### f) Public Debt

24. The regions level of public gross nominal debt averaged 41.2 percent of GDP over the period under consideration. However, a number of countries had debt to GDP ratio of over 60 percent (figure 8). The relatively low levels of debt can be largely attributed to debt relief initiative that benefited a number of countries in the region. However, countries in the region are resorting to accumulate domestic arrears to finance budget deficits thereby exacting pressure on domestic interest burden.

**Figure 8: Public Debt (**as a percentage of GDP**)**




*Source: Based on IMF Staff Reports Data*

25. The low public debt levels in the region suggest that concerns about fiscal sustainability are perhaps less of a constraint at the moment. However, there are concerns that fiscal policy in most African countries is pro-cyclical, being expansionary during economic booms and contractionary during economic depression (Ilzetzki and Vegh, 2008). The challenge with pro-cyclical fiscal policy is that they tend to prolong depressions or conversely slow down economic expansions. The case for counter cyclical fiscal stimulus depends on the individual circumstances. Beside short term stabilization, fiscal policy is an instrument for addressing various market failures, improving resource allocation and efficiency, increasing long term growth, and addressing distributional equity and social inclusion. The other challenge that is less obvious is the pressure of domestic debt on the overall debt. A number of Member States raise a substantial amount of resources from the domestic market resulting in higher interest payments reflecting higher than expected nominal interest rates and higher stock of domestic debt.

## *V. Recent Fiscal and Structural Reforms in Member Countries*

26. Most COMESA member countries have been undertaking three major types of structural adjustments in fiscal area in the last decade namely: (i) privatization or liquidation of public enterprises, and improvements in pricing and efficiency in those that remain; (ii) improvements in the tax structure and improvements in tax administration; and (iii) introduction of Public Finance Management Reforms and preparations of Medium Term Financial Frameworks.

**(a) Privatisation and liquidation of public enterprises**.

27. Significant progress has been made in most member countries in undertaking comprehensive reforms of public enterprises. There were some delays in few countries in privatizing all public enterprises because of the legal and technical complexity of the process of liquidation and privatization. Considerable difficulties were faced in few countries in finding credible private sector purchasers with the required capital. Many member countries generated a significant amount of funds from privatization. For those enterprises that remained in the public sector in some countries, there was an effort to improve the quality of management by granting them autonomy and providing incentives through a variety of performance contracts specifying clear objectives. In general, the main focus of public enterprise reforms which did not involve privatization was to improve efficiency of public enterprises by reducing their reliance on budget subsidies and use of bank credit. Removal of credit subsidies and reduced reliance on bank credit of existing public enterprises in some countries released financing for the private sector.

**(b) Tax reforms and tax administration**

28. Many member countries undertook the following tax reforms:

(i) Significant attempt has been made by most member countries to reduce reliance on the taxation of international trade and to shift the tax system toward domestic transactions and sources of income.
(ii) VAT was introduced in almost all member countries. Tax reforms have also been instrumental in shifting excises from a specific to an advalorem valuation basis.
(iii) Almost all countries have simplified and improved the equity and efficiency of their personal income taxes by scaling down the highest marginal rates, reducing the number of rates, and reducing exemptions and deductions.
(iv) Tax administration in almost all countries has improved through better training, salaries and conditions of service for revenue collection personnel. Special emphasis was placed on providing adequate trained manpower and other infrastructural facilities to enable the attainment of revenue potential. See below (in Box 1) general lessons for tax administration from international best experience.

**Box 1: General Tax Administration Reform**

The following are some general lessons for tax administration reform from international experience which can be applicable to COMESA region.

**Goals**

The reform of tax administration systems must follow simple transparent goals that bring enforcement closer to the most important objectives of tax policy. Goals for tax administration reform include the following:

(i) increasing the effectiveness, efficiency, and integrity of tax administration systems.
(ii) improving fairness of the tax system.
(iii) broadening the tax base.
(iv) improving tax compliance.

**Modernizing Tax Administrations and Improving Revenues and Compliance**

International experience shows several critical steps that should be followed in the modernization of tax administration to improve collection and compliance:

(i) reorganize tax administration along functional lines (collections, audit, etc., as opposed to by tax); merge customs and tax administration and collect social security contributions with tax administration.
(ii) decentralize the organizational structure by adopting semiautonomous revenue agencies and creating large-taxpayer units; introduce highly automated information technology systems driven by final users (for registration, audit, and taxpayer education).
(iii) promote voluntary compliance by establishing self-assessment systems, taxpayer education programs, e-filing, and pre-populated income tax returns. In addition, use public relations campaigns to draw attention to the benefits of taxes (e.g., public services), and introduce reasonable appeals and dispute resolution systems.
(iv) develop tax audit capabilities with risk assessment (audit selection) programs, computerized third-party information systems, and record matching.
(v) fight corruption by implementing a modern code of conduct and ethics, increasing flexibility in setting wages and career promotion and staff training, strengthening specialized internal audit for enforcing the code of ethics, and removing opportunity by using e-filing.

**Increasing Detection and Punishment: The Enforcement Paradigm**

The effectiveness of tax enforcement and voluntary compliance depend critically on the perception that evaders are likely to be caught and if so, punished. General reforms in this direction include the following:

(i) increase the number of audits, either by hiring additional auditors or by contracting out audits to private sector firms.
(ii) improve the quality of audits and auditors.
(iii) increase penalties for tax cheating, such as the interest rate on unpaid taxes.
(iv) publicize tax evasion convictions in the media as an alternative nonfinancial type of penalty.
(v) improve the effectiveness of audits via adoption of modern audit technology, including more systematic selection of returns for audit and greater use of "scoring" tax returns.
(vi) improve state government follow up on taxpayers found to be noncompliant with the federal personal income tax.

**Changing the Culture of Paying Taxes: The Service Paradigm Again**

The services of the tax administration can be improved by becoming more consumer-friendly, following the service paradigm by:

(i) promoting taxpayer education;
(ii) providing services to assist taxpayers in filing returns and paying taxes;
(iii) improving phone advice services;
(iv) improving tax agency websites;
(v) simplifying taxes;
(vi) simplifying the payment of taxes;
(vii) simplifying tax forms;
(viii) using mass media to reinforce tax compliance as the social norm, and publicize tax cheats;
(ix) emphasizing the link between payment of taxes and the receipt of government services;
(x) targeting certain groups (e.g., new firms or employees) to introduce from the start the notion that paying taxes is the social norm;
(xi) enlisting other organizations to promote compliance, so that it is seen (again) that paying taxes is the accepted pattern of behavior;
(xii) avoiding individuals who think cheating is acceptable; a tax amnesty is a classic example of sending the wrong signal; and
(xiii) addressing perceived inequities in the ways people feel that they are treated.

Source: Jorge Martinez Vasquez , *"Taxation in Asia",* African Development Bank, 2011

### (c) Public Finance Management Reforms and preparations of Medium Terms Financial Framework (MTFF)

29. Another area that received increased attention in fiscal reform of member countries in recent years are:

(i) Improving the transparency of budget accounts. In this regard many countries introduced Public Finance Management System (PFM). PFMs require that the budget is comprehensive by including all financial operations of the Government. Thus both the current and capital budget should be included under one budget and aid and debt, as well as other off-budget items (including contingent) must be captured in the budget. Such a comprehensive sweep of the budget would facilitate coordinating fiscal policies within a macroeconomic policy framework and enable assessment of the sustainability of fiscal policies over the short and medium term. Having a robust PFM by member countries is one of the requirements of the COMESA Multilateral Fiscal Surveillance Framework. See below (Box 2) the minimum desirable characteristics of Public Finance Management System.

**Box 2: Public Finance Management** *(Minimum Desirable Characteristics)*

| **Budget formulation and planning** |
|---|
| → "Top-down budgeting and strong centralized agency (usually the ministry of finance) responsible for preparing the budget;<br>→ Comprehensiveness of the budget (current and capital budget, contingent liabilities, aid and debt receipts and expenditures);<br>→ Budget classification system consistent with international standards;<br>→ Fiscal rules limiting discretionary authority of the budget agency;<br>→ Medium-term macroeconomic and fiscal context to guide annual budgeting exercise (Medium-Term Macroeconomic Framework – MTMEF, and Medium-Term Fiscal Framework – MTFF, plus sectoral Medium-Term Expenditure Framework – MTEF);<br>→ Consistency between debt management policies and other macroeconomic policies;<br>→ Inclusion of cyclical and 'risk' factors. |
| **Budget approval** |
| → Clear timeline for the submission and approval of annual budget proposals;<br>→ Submission by the Government a comprehensive set of documents supplementing the budget proposals to enable legislature to scrutinize budget proposals;<br>→ Limited powers of legislature to amend the overall revenue of expenditure ceilings proposed by the Government. |
| **Budget execution and post audit** |
| → Budget monitoring based on management information system;<br>→ Internal controls on spending;<br>→ System of internal audit in individual ministries; |

| |
|---|
| → Independent external audit;<br>→ Reconciling of fiscal and banking records. |
| **Transparency** |
| → Medium-term budget frameworks (MTBF);<br>→ Fiscal risk disclosure (FRD);<br>→ Minimal and transparent off-budget items;<br>→ Inclusion of contingent liabilities (public guarantees, PPP obligations, etc.);<br>→ Effective accounting standards;<br>→ Regular in-year fiscal reporting;<br>→ Issuance of consolidated financial statements on timely basis;<br>→ Publication of report on the reconciliation of budgeted and outturn expenditures;<br>→ Appropriate corrective actions on the findings of budget and audit reports. |

Source: COMESA, "*Facilitating Multilateral Fiscal Surveillance in Monetary Union Context with focus on COMESA Region",* 2011

(ii) Many Member countries are making significant progress in preparing their budgetary policies within a comprehensive medium term financial management framework, comprising a set of four separate frameworks: A Medium Term Fiscal Framework (MTFF), a Medium Term Budget Framework (MTBF) and Medium Term Expenditure Framework (MTEF). The COMESA Multilateral Fiscal Surveillance Framework is based on the availability of all the four components of the Medium Term Financial Management Framework. However, their development in member countries is constrained due to insufficient availability of data, and capacity for data analysis which could only be built from the medium to long run. See below (in Box 3) the stages of preparing a Medium Term Expenditure Framework.

**Box 2: Medium-term expenditure frameworks**

According to the World Bank's Public Expenditure Management Handbook, (1998, P.46), the MTEF "consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and, ultimately, the matching of these costs with available resources ….. in the context of the annual budget process". The top-down resource envelope is fundamentally a macroeconomic model that indicates fiscal targets and estimates revenues and expenditures, including government financial obligations and high-cost governmentwide programs, such as civil service reforms.

To complement the macroeconomic model, the sectors engages in bottom-up reviews that begin by scrutinizing sector policies and activities (similar to the zero-based budgeting approach), with an eye toward optimizing intrasectoral allocations. MTEFs are receiving renewed attention in the formulation of poverty reduction strategy papers as an appropriate instrument for incorporating PRSP strategies into public expenditure programs. The basic characteristics of MTEFs are described in the following table:

| **Stages of preparing a medium-term expenditure framework** | |
|---|---|
| **Stage** | **Characteristics** |
| Development of macroeconomic and fiscal framework | Macroeconomic model that projects revenues and expenditure in the medium term (multiyear) |
| Development of sectoral programs | Agreed sector objectives, outputs, and activities<br>Review and development of programs and subprograms<br>Estimated program cost |
| Development of sectoral expenditure framework | Analysis of inter- and intrasectoral trade-offs<br>Consensus-building on strategic resource allocation |
| Definition of sector resource allocations | Medium-term sector budget ceilings (cabinet approval) |
| Preparation of sectoral budgets | Medium-term sectoral programs based on budget ceilings |
| Final political approval | Presentation of budget estimates to cabinet and parliament for approval |

Source: World Bank, *"Medium-Term Expenditure Framework: From Concept to Practice. Preliminary Lessons from Africa".* Working Paper Series 28, Washington DC, 1998

## *VI. Recommendations for Enhancing domestic resource mobilization*

### a) Public Resource Mobilisation

30. The global economic crisis has shown how uncertain external flows are for COMESA region. Many members faced reduced export revenues. Considerable uncertainty was also experienced with regard to future foreign direct investment and aid inflows, while high level of indebtedness remained a concern. In fact the global economic crisis has given a new impetus to dialogue on domestic resource mobilization in Africa, to effectively and sustainably bridge the persistent development financing gap. The recent global uncertainty poses important challenges to fiscal policies in COMESA member countries. Public finances are under additional strain in the region as aid providers are facing at home significant fiscal shortfalls and are forced to take severe fiscal adjustment measures. These factors, combined demonstrate the importance of increasing domestic resources in COMESA region. Monterrey Consensus on financing for development acknowledged earlier in 2002, external financial resources for development are inadequate towards meeting the MDGs. The Monterrey Consensus thus stressed the necessity to develop new strategies by mobilizing domestic resources. It is worthwhile to note that enhancing domestic resource mobilization is necessary to create fiscal space and increase the ability of fiscal policy to effectively perform the roles which are mentioned in section II. The following are recommendations to enhance domestic public revenue mobilization:

(i) Sustained economic growth is a necessary condition for successful revenue mobilization. A growing economy has better potential to create formal sector employment and increase the pool of tax payers. It also increases potential revenue from indirect taxes. But growth will generate more revenue if there is structural change, improved economic policies, and better tax administration. In most COMESA member countries; agriculture accounts for a very large share of GDP and employment. Furthermore, a large part of the labour force employed in agriculture is in the informal sector where taxation is difficult. Diversification of the production sector is needed to bring more people into the formal sector and increase the pool of tax payers. Such structural change will also reduce dependence on commodities which tends to increase volatility of government revenue with serious consequences for output and the provision of public goods.

(ii) There is considerable scope for increasing revenue through reducing tax exemptions on corporations, increasing VAT rates on luxury consumption items, and making more efforts to boost revenue from property taxes and excise duties.

(iii) Bring the informal sector into the tax net: A number of approaches have been adopted in some African countries that could provide a way forward. For example, the Ghana Internal Revenue Service has negotiated with the Ghana Private Road Transport Union to use the Union as a tax collection agent under the Identifiable Grouping Taxation (IGT) scheme. The IDT levies small and affordable taxes that are collected daily or weekly from both the formal and informal union members. Algeria is using a presumptive tax for mainly informal entrepreneurs. In Zambia, a flat-rate 'base tax' for rural areas has been introduced along with presumptive taxation of 3% on gross income for urban areas. Additionally a 'peddler's license has been issued for street sellers.

(iv) Reliance on trade taxes in an environment characterised by increased global economic integration poses considerable difficulties for African countries.

Reducing vulnerability from this source requires efforts to increase revenue from non-trade taxes through diversification of the tax structure,

(v) Need for better tax and customs administration. Inefficiencies in fiscal administration reduce the capacity of governments to mobilise revenue, as well as encouraging tax evasion. There is growing consensus that sustained efforts to improve tax and customs administration will increase tax revenue without the need to raise rates on existing taxes. Computerisation of tasks, improved tax audits and reporting, and training of tax officials are examples of important steps needed to address inefficiencies in fiscal administration. In this regard, there is the need for international assistance in building capacity in the region.

(vi) Reducing improper transfer pricing: Improper transfer pricing is an international problem that affects developed and developing countries alike. Multinational enterprises operating in COMESA Member Countries might take advantage through different tax regimes, including tax havens, under invoice or over invoice for good and services, and financial transactions to maximize after tax profit at the expense of the host country. The general consensus towards reducing transfer pricing abuse requires countries to develop specific legislative measures that are adapted to their legal system, and economic context, and to build the administrative experience needed to enforce them.

(vii) Enhancing extractable natural resources revenue: The region's vast natural resources- are already an essential revenue source for many member countries. However, the widely held view is that the region gets less from its natural resources than elsewhere in the developing world. There are varied reasons for this- including contracts often subjected to confidentiality; and corruption often blamed for the secrecy. The Extractive Industries Transparency Initiative (EITI) offers the unique purpose of increasing the transparency of transactions between companies and government entities, and of the use of revenues by governments concerned.

(viii) Curtailment of illicit financial flows. These constitute all money that is illegally earned, transferred, or utilized, including proceeds of theft, bribery and other forms of corruption by government officials, proceeds of criminal activities including drug trading, racketeering, counterfeiting, contraband and terrorist financing and proceeds of tax evasion and laundered commercial transactions.

(ix) Good governance is important for successful resource mobilization. Tax evasion and avoidance tend to be high in economies where there is weak governance. Households and firms are less likely to take their tax responsibilities seriously in economies with a high incidence of fraud or corruption. At the national level, there is the need to improve efficiency and accountability in the use of public resources. Linking tax collection to service delivery, better public financial management, and more transparency in resource use are necessary to accomplish this objective. Good Governance is also needed at the international level. For example, OECD countries need to take measures to eradicate tax havens and should make it very difficult for public officials from developing countries to hide stolen assets in their financial institutions. Dealing with the governance problems at the national level without addressing these global governance issues will be counterproductive

(x) Successful mobilisation of domestic revenue in COMESA region requires dealing with the external debt problems of the region. High external debts result in future capital out-flows and often creates debt-servicing difficulties with consequences for resource mobilization. External debt also affects resource mobilization by increasing vulnerability to shocks thereby contributing to macroeconomic instability which constrains growth. Because of these drawbacks, it is often suggested that African governments should finance activities through domestic rather than foreign borrowing. While domestic borrowing seems more appealing than foreign borrowing, because it does not involve exchange rate risk, it also has limitations. When governments raise money through issuing bonds locally, it puts pressure on real interest rates and may reduce private sector credit with consequences for private investment. Domestic borrowing can create a medium to long term fiscal sustainability problem and this should be taken into account when borrowing decisions are made. It should be recognized that the ability of African governments to raise money through this source is limited by the shallowness of domestic financial markets.

(xi) Sustainable reduction in fiscal deficit may be achieved through reducing nonproductive spending such as in prestige projects, spending on none targeted subsidies, and restructuring civil service to a lean efficient outfit, among others

(xii) Public enterprise reforms. Most countries in the region have been reforming public enterprises that have been a heavy burden on the already strained budgets. Most countries have made considerable effort in restructuring public enterprises, improving quality of management including use of performance contracting, improving efficiency and reduced or eliminated reliance on budget subsidies.

(xiii) Member countries need to speed up the pace of fiscal reforms and in particular strengthen institutional capacity for reforms through sustained implementation of public finance management reforms, including enhancing the process for appraisal, selection, implementation, and audit of investment projects; improve coordination in the budgeting process, promotion of fiscal transparency; and strengthening the medium term orientation for fiscal policy framework. Fiscal reforms should however safeguard social safety nets, address infrastructure gaps, and ensure mobilization of additional revenues. Focus should be on responding to growing demand for public service as population grows especially in education, health care, and infrastructure, requiring a combination of revenue mobilization and, careful priority and efficient spending. Ultimately, countries must ensure long-term fiscal sustainability and maintenance of a tax burden that does not harm growth.

(xiv) There is need for careful spending choices that ensure sustainability of social spending and public wage bill and at the same time achieving efficiency gains while paying due regard to equity. Most countries in the region are incorporating the aspect of sustainability by incorporating expenditure rules in their public finance management systems. The success and sustainability of these reforms is anchored on transparency through extensive political consensus building and a

broad communication strategy. There is need for comprehensive and regular analysis of fiscal risks that may emanate from macroeconomic and governance related shocks in order to detect and prevent rent seeking.

(xv) More importantly, countries in the region need to ensure that countercyclical policies during down turns do not lead to long term deterioration in fiscal sustainability. There is need for prudent, sustainable fiscal stance over the medium term particularly the need to build up fiscal buffers during booms to cushion the economy during depressions. For instance, COMESA member countries should take advantage of economic recovery in United States and Europe to strengthen fiscal buffers and reduce vulnerability to downside risks. It is also important to note that fiscal vulnerability for COMESA region emanates from over reliance on foreign aid and commodity exports to generate revenue. Foreign aid flows to these countries has been declining and especially grants adversely affecting aid dependent countries in the region. Most member countries rely on commodity exports whose world prices tend to be volatile resulting in high revenue volatility in these countries

**b) Developing Private Sector Resource Mobilisation**

31. During the past decade all the region's governments have embraced the private sector led development strategies. Spurred by encouraging results on the ground, this development paradigm has received increased attention by policy makers and the development community at large.

32. Governments do not have direct control over private sector domestic resource mobilization. However, they can contribute to its mobilization indirectly through creating a good physical and social environment as well as adopting sustainable fiscal policies which will contribute for macroeconomic stability. Some of the factors constraining mobilization of private savings in the region include: weak domestic financial infrastructure and systems; high dependency ratio; uncertainty associated with macroeconomic policies; capital flight and weal governance. The following are recommendations to enhance private domestic resource mobilization in the region.

i) Strengthening domestic financial institutions by providing market incentives that encourage financial institutions to mobilise savings and channel them into productive investment. For example, the development of markets for long term government bonds and provision of public guarantees, for a given percentage of bank loans, could reduce risks faced by domestic banks and create an incentive for them to engage in long term lending. Governments could also influence private resource mobilization through promotion of linkages between formal and informal financial institutions. Establishing linkages between formal and informal financial institutions will improve access by small-scale businesses to financial services. Governments should also rebuild public financial institutions such as development and agricultural banks in order to expand the basis for savings and provide long-term development finance.

ii) Capital market development can contribute to private domestic resource mobilsation in the region. The development of capital markets in the region is constrained by limited market size, weak financial market infrastructure, lack of equity capital, difficulties in obtaining information; absence of appropriate regulatory frameworks, weak governance; and lack of investor confidence in stock exchanges.

iii) Microfinance institutions can also contribute to the mobilization of resources especially in the rural areas and the urban informal sector

iv) Capital flight represents a serious obstacle to mobilization of resources in the region. Better governance and law enforcement, as well as economic policy reforms and political stability are required to reduce the incidence of capital flight.

v) Create alternative source of funding to bank lending by stimulating domestic savings and creating new financial instruments for portfolio diversification and financial risk management. This includes development of corporate bond markets. For example, the Kenya government issued three vanilla infrastructure bonds between 2009 and 2010, and all the issues were oversubscribed. The development of the corporate bond markets and equity markets are hinged on sound legal and regulatory frameworks.

**c) Other sources of Resource mobilization**

(i) Remittances; the remittances migrants send back to their families are a major source of income in many countries and significantly contribute to poverty reduction. The regions total remittance increased from US dollars 3.9 billion in 2000 to over US dollars 22.3 billion in 2014. Remittances will continue to significantly contribute to private savings in the regional economies and could easily be tapped for development needs of the region. However, remittances inflows remain unpredictable and are subject to high transaction costs in the short term.

(ii) Issuance of Sovereign Bonds. Recently a number of countries having issued sovereign bond including Egypt in 2001, Seychelles in 2006, Congo DR in 2007, Rwanda in 2013, and Ethiopia, Kenya and Zambia in 2014.

(iii) Continued support for the African Financial Market Initiative, an initiative of the African Development Bank launched in 2008, is paramount to strengthening domestic resource mobilization efforts in the operational direction of private equity funds and bond markets.

(iv) Most countries in the region will remain reliant on Official Development Assistance (ODA). This has been playing an important role in closing the financing gap in the short run especially given the low savings rate and

limited access to international capital markets for most countries in the region. ODA can be more effective for domestic resource mobilization if linked to actual revenue generation in recipient countries. For example, donors could reach an agreement with recipient countries that they will match a certain percentage of the funds generated by recipients subject to a fixed limit. The initial limit could be set based on agreements with recipients and it could be reduced as recipients increase capacity to mobilise domestic resources. This matching-funds approach will create an incentive for governments to take necessary actions to boost domestic revenue. It will also increase transparency and efficiency in the use of public resources. It is worthwhile to note that reliance on foreign aid is facing serious head winds including donor fatigue, many unmet conditionalities, mismatch between pledges and actual disbursements, and changing motives by donors which make access to aid more difficult. Falling foreign aid resources and volatility of commodity prices have only made the situation worse, calling for renewed efforts to accelerate mobilization of domestic resources as well as for reforms to increase spending efficiency.

**d) Resource mobilization to enhance regional integration**

33. COMESA region has a resource base to support regional integration. The following are some of the instruments that can be used to enhance regional integration:

(i) Ensure the COMESA Infrastructure Fund is fully funded, in order to address infrastructural development needs of the region.
(ii) The Nation Agricultural and Food Security Investment Plans resulting from the Comprehensive Africa Agriculture Development Programme (CAADP) compact should form one basis for mobilizing finance for the agricultural sector in the region.
(iii) COMESA should seek for innovative means of resource mobilization, such as levy on insurance premium, levy on international travel etc. in order to finance its regional projects.

## *VII. Summary and Conclusions*

34. In COMESA region as elsewhere, fiscal policy can and should be used effectively to foster growth, reduce short term fluctuations of economic activity and maintaining economies close to their potential growth paths. The necessity to carry out these tasks is emphasized by the following conclusions:

(i) Domestic revenue to GDP ratios remain low for most member countries (figure 2) attributed to among others low per capita income and growth, institutional problems and weak governance. Addressing these challenges provides a case for fiscal policy in domestic resource mobilization.

(ii) Improved fiscal policies are needed to increase revenue mobilization. These policies include, reducing tax exemptions and incentives, increasing VAT rates on luxury consumption goods, increasing the outreach of property taxes and excise duties, reducing dependence on trade taxes through diversification of the tax structure, among other policies.

(iii) Addressing inefficiencies and improving tax and custom administration through computerization of tasks, improved tax audits and reporting, and training of tax officials among others, increases tax revenue without the need to raise rates of existing taxes.

(iv) Good governance is required in order to deal with corruption, tax evasion and avoidance and to link tax collection to service delivery. Improving efficiency, better public finance management, accountability and transparency in the use of public funds are important in enhancing domestic resource mobilization.

(v) The need to contain external debt to sustainable levels is necessary for enhancing domestic resource mobilization. High external debt results in future capital outflows and often creates debt–servicing difficulties in the short-run. High debt increases vulnerability to shocks thereby contributing to macroeconomic instability which constrains growth. Alternatively, domestic borrowing is equally problematic since it exacts pressure on domestic real interest to rise, reducing private sector credit, private investment and growth, which in turn adversely affects domestic resource mobilization.

(vi) The public sector can contribute to domestic resource mobilization by indirectly boosting private savings through a number of ways including creating a good physical and social environment as well as adopting appropriate economic policies. Policies to address the high cost of doing business, raise incomes, address weak domestic financial infrastructure and systems, promote capital market development and financial inclusion, reduce dependency ratio, ensure macroeconomic stability, reduce capital flight, ensure good governance and political stability will significantly boost private savings which in turn will enhance domestic resource mobilization.

(vii) Public investment is essential for fostering growth in the region, which implies a pragmatic approach to fiscal deficits. If a country's long-term average growth rate is low, as is the case for most member countries, it is appropriate to increase public investment in order for the country to reach its long term potential. Similarly, governments can use current expenditure as the counter-cyclical mechanism to generate the additional demand necessary to reach the greater

potential created by the public investment. Using current expenditure to compensate when private demand is insufficient to keep growth near its potential implies increasing fiscal deficits or reducing surpluses.

(viii) The use of fiscal deficits for counter-cyclical management and to fund public investment need not be inflationary. Inflation in most member countries has a strong structural component which can be addressed through growth and development of economic and financial infrastructure rather than through deficit reduction.

(ix) Increasing public revenue requires rational approach to foreign investment based on explicit assessment of costs and benefits. It is rational policy to maximize the benefits of foreign investment, including the revenue benefits.

(x) In COMESA region, private saving is constrained by poverty of households and the underdevelopment of the so called formal sector. Raising savings rate will be a long term task, achieved through the development of medium and large scale private enterprises and rising income of the workers. Governments should also pursue aggressive policies of financial system development.

(xi) Research indicated that for more than forty years, 1965-2006, 40% of development assistance went to domestic consumption, more than one third to capital outflows and only one quarter to domestic investment. This distribution, contrary to all principles of fostering growth and development, could be changed with donor flexibility.

(xii) Remittances from both workers who are temporarily abroad and long-term diaspora households represent a potential albeit small source of domestic investment. Governments design schemes to bring some remittances into formal financial channels, while accepting that the high consumption rate of remittances limits the potential to do so.

(xiii) Reversal of capital outflows, “capital flight” could have a dramatic impact on resource mobilization. Independent research suggests these outflows were enormous. Capturing even a small part of capital outflows could dramatically increase public revenue.

## Annex 1. Elements of COMESA Multilateral Fiscal Surveillance Framework (MFSF)

- Establishment of a Convergence Council with membership of the Ministers of Finance, Governors of Central Bank and Ministers of Trade with the responsibility of multilateral surveillance.
- All member countries undertake review of PFM Systems based on PEFA assessment and formulate PFM reform programmes. Member countries which did not have a previous PEFA assessment should undertake that exercise with outside assistance. If this is not possible they may make a self-assessment on PEFA model that will form the basis for their PFM reforms;
- An 'Excessive Slippages Procedure' (ESP) should be established as the heart of the MFSF. The following are the salient points of the Guideline on Excessive Slippage Procedure.

    - In addition to budget deficit, convergence criteria should include a quantitative debt ratio expressed either as a 50% of GDP, or 250 percent of government revenue (excluding grants), with the other as a warning "benchmark ratio";
    - Embed trade integration surveillance with fiscal surveillance by including as a "bench mark" a member State's improvement in its ranking in World Bank's Doing Business Index to cluster within 5 ranking numbers of the average of the three best Member State performers;
    - Each Member State should be required to formulate and implement a Medium Term Country Convergence Programme (MTCCP) indicating its objectives, targets, and intended policies aimed at reaching at its own prioritizing and sequencing, but in a reseanable time period;
    - The MTCCP should be submitted to the Convergence Council for its approval and assessment that it is consistent with the aims and objectives of the regional integration programme and subsequently to the country's national assembly to give it a legal status;
    - Slippage is defined as the excess in the actual realization of budget deficit, or debt ratio over the MTCCP target.

- A COSWAP Facility to provide liquidity in case of financial crisis in a member country should be set up. Governors of the Central Banks will work out its modalities. The following are the salient features of the Facility:

    - The facility addresses the short term balance of payment difficulties that member states may incur, thereby fulfilling the "crisis management aspect of the surveillance framework;
    - The facility will have its own resources, subscribed by member countries and supplemented by possible further contribution from development partners. The drawing rights of Member States will be related to their subscription to the Facility;

- Member countries contribution to the facility should be an amount equal to the lesser of the amount of foreign exchange reserves a Member State holds over and above a thresh hold equivalent of two and half months' imports, or an amount equal to 10% of that excess. Countries that have less than the threshold amount will only make a token payment of say US$1 million to the facility, but would be expected to make the required contribution once their reserves exceed the threshold, calculated in reference to the imports of the base year when the Facility becomes operational;
- Member countries maximum drawing eligibility should be a multiple of five of its subscriptions, subject to a minimum of SDR 20 million and a maximum of SDR 100 million;
- The managing Committee will have five members who are also the members of the Convergence Council;
- In its initial stages, the Facility will operate as a swap facility whereby the borrower Member State would swap its currency for equivalent convertible currency from the lending country;
- This arrangement would last until a monetary union is established and a single currency is in circulation when the contribution amounts will be deposited in a common pool with the COMESA Central Bank. The following are the eligibility criteria for the use of the Facility's funds:

    - ✓ Member state has made its calculated contribution to the facility;
    - ✓ The Member State has incurred, or is facing an immediate balance of payments crisis due either to external circumstances or policy slippages from its Convergence Programme;
    - ✓ The Member State has a 'use of fund resources' arrangement with IMF, or has requested the Fund for such assistance and the IMF has expressed its readiness to negotiate a suitable arrangement with the Member State; and
    - ✓ The amount of assistance from the Facility will be decided by the Managing Committee of COSWAP, subject to the maximum rights allotted to the Member State.

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