Revenue Diversification: Non-Traditional Sources of Development Finance as Game Changers in Africa

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Abstract

It goes without saying that Africa needs a significant quantum of resources to address its development challenges. The World Bank estimates Africa's infrastructure needs at USD 93 billion per annum and we estimate the social sector development needs at USD 109 billion per annum. We also find that the major sources of development finance in Africa are exhibiting either a declining or a constant trend. This, therefore, calls for significant increases in the fiscal space in which non-traditional sources of development finance can be game changers. This study discusses five sources of financing that are currently used by a relatively small number of African countries in spite of their potential to increase their fiscal space. Diaspora bonds, carbon sequestration and trading, renewable energy and Islamic finance, as sources of development finance are non-traditional to many African countries. Tourism is traditional to all African countries, but is not optimally leveraged as in other parts of the world. We argue that African countries are not looking at the full range of options that could be available to them to increase the development finance space. We therefore argue that African policy makers should embark on revenue diversification to include non-traditional sources that could be game changers in their development finance mix.

Keywords: non-traditional source, development finance, carbon sequestration, diaspora bonds, remittances

1. Introduction

It goes without saying that Africa needs a significant quantum of resources to address its development challenges. For many African countries, non-traditional sources of development finance could be game changers in expanding the development finance space. We define a non-traditional source of development finance simply as one that is not traditional to a country. It is country-specific and a source that is non-traditional in country A could be traditional in country B and vice versa. We shall examine five sources of finance that are currently used by a relatively small number of African countries in spite of the potential to increase the fiscal space for many African countries. We argue that African countries are not looking at the full range of options that could be available to them to increase the development finance space. For example, almost 90 years after diaspora bonds were first issued by China and Japan, coupled with the fact that Israel has been able to raise USD 40 billion since 1951 to finance infrastructure, only two African countries (Ethiopia and Kenya) have so far issued such bonds. This is so in spite of an estimated 40 million Africans living outside the continent and saving an estimated $53 billion in those destination countries each year (Plaza & Ratha, 2011). On carbon trading, more than a decade after the Clean Development Mechanism (CDM) started issuing Carbon Emission Reductions (CERs), Africa accounts for only little more than 1% of CDM projects worldwide and only 2.2% of the carbon credits as of 8 September 2016. The primary and secondary CDM markets were estimated to be worth USD 11.9 billion in 2007.

Even though Africa is a huge potential source of solar, hydropower and wind energy, besides Morocco, no African country is trading excess energy to other parts of the world. Islamic finance has become one of the fastest-growing segments of the global financial system and its instruments have been successfully leveraged to finance infrastructure development in Malaysia, Bahrain and Indonesia, yet only six countries have issued them...
so far, although five more are actively looking into issuing them. The UN World Tourism Organization (UNWTO) estimates that African counties would continue to receive the least number of international tourist arrivals even by 2030 (7%), which is a marginal increase from the 6% projected for 2020.

African countries cannot depend entirely on their traditional sources of development finance; they have to include non-traditional ones. This is more so as traditional aid donors such as the EU, is increasingly having to attend to acute development challenges at home. We argue that revenue diversification to increase fiscal space is a sine qua non for sustainable development. This paper, therefore presents a number of non-traditional sources that can potentially increase fiscal space. African policy makers can consider including some of them in their arsenal by investigating the ability of the sources to generate fiscal space given their country-specific circumstances and various policy environments.

This paper is set out in four sections including this introduction. Section II presents the demand for development finance to meet Africa’s economic infrastructure and basic social services’ needs, computes the adequacy of readily available resources (domestic revenue, remittances and official development assistance (ODA)) and shows that existing sources are in no way commensurate with the needs of the continent. Hence, the need to bring non-traditional sources into the development finance mix. Section III presents four sources that are traditional to few African countries and non-traditional to many and additional source that is traditional to many but not optimally leveraged as it is the case in other parts of the world. The paper ends with a conclusion in section IV.

2. The Demand for and Sourcing of Development Finance

The demand for development financing in Africa is enormous. The World Bank estimates Africa’s infrastructure needs at about USD 93 billion a year (15 percent of the region’s GDP) (World Bank, 2010). USD 25 million out of the estimate above is for irrigation, water and sanitation services while the rest goes to finance ICT, power and transport. In addition, there are non-infrastructure financing needs to address goals such as the Sustainable Development Goals (SDGs) (Note 1). The UNMP (2005) assessed the financing needs to meet the Millennium Development Goals (MDGs) (Note 2) and undertook this assessment in five countries including three in Africa: Ghana, Tanzania and Uganda. It estimated on average the financing required to meet hunger, education, health, gender equality and slum upgrading goals by 2015 at USD 87, USD 99 and USD 88 per capita per annum respectively for the three African countries. If the UN 2015 population estimates for these countries are used, the average stands at USD 92.6 per capita per annum. With a population estimated at 1.186 billion in 2015 (UN, 2016), Africa would need USD 109 billion to meet these non-infrastructure needs. In addition to the WB estimates for infrastructure needs, the total amount stands at USD 202 billion per annum. The foregoing estimates would be the minimum financing needs of African countries because the MDG-related goals have now been replaced by more ambitious SDGs, which may require more financing. In July 2015, at the Financing for Development Conference held in Addis Ababa, the Multilateral Development Banks pledged USD 400 billion for the period 2016 - 2018 to finance global development, which averages at USD 133 billion per annum. Noting that these estimates are not for African countries only, the need to significantly increase their domestic resources to meet their development challenges cannot be overemphasized. This fact was underscored at the same summit during which domestic resources were identified as one of the main sources of financing for the SDGs (UN, 2015).

In spite of these financing needs, the major sources of development finance in Africa have either a declining trend (net ODA per capita in current USD), or a constant one as in personal remittances (as % of GDP), revenue (excluding grants (as % of GDP)), and net ODA (as % of GNI) (see Figure 1).

![Figure 1. Trends of major sources of development finance for SSA (developing)](source: Data from WB WDI)
3. Non-Traditional Sources – An Old New Window of Opportunity

In light of the foregoing, African countries need to explore non-traditional sources of development finance that could be game changers for them. Moreover, for development to be owned, the resources to finance it have to be nationally owned. Consequently, if African countries have to be in the driver’s seat and own their development, then African domestic resources would have to be the largest component of development finance. Official development assistance (ODA) can help but only as a complement. Development partners such as the International Monetary Fund are supporting the countries in increasing their fiscal space through efficiency gains in traditional tax management and administrative reforms. Such efforts are proving to be very fruitful; however as shown above, the development needs outstrip the financing available. Consequently, non-traditional sources have to be identified to complement the traditional ones.

An extremely small number of African countries is leveraging a number of non-traditional sources, leveraged in other regions of the world to finance development in spite of the huge potential of such sources. The non-traditional sources that are examined in this study are diaspora bonds, carbon sequestration and trading, renewable energy and Islamic finance instruments. In addition, tourism, which is a traditional source for almost all countries, but not fully leveraged on the continent, is also examined. Shimeles (2010) identified three such sources: remittances, diaspora bonds and securitization of future receivables. In a similar vein, the UNDP (2011) catalogued a number of global mechanisms (Note 3) identified by several academic and policy studies to raise development finance while examining the prospects of non-traditional sources of development finance in the context of Ethiopia. The non-traditional sources examined in this study are presented below.

3.1 Diaspora Bonds

Diaspora bonds, which are debt security instruments designed for a country’s diaspora to finance large-scale infrastructure development projects, have been used since the 1930s when China and Japan issued the first, followed almost twenty years later by Israel and India. Israel has raised more than $40 billion via diaspora bonds since 1951 (Strohecker, 2016). The annual borrowing policy of the country is actually defined by the Ministry of Finance according to the government’s foreign exchange requirements and systematically includes diaspora bonds issuance (Kayode-Anglade & Spio-Garbrah, 2012). Interest in diaspora bonds reemerged with increased remittances and the acknowledgement by development practitioners and governments that diaspora savings could be channelled to finance domestic infrastructure needs (Burgess & Perez-Armendafiz, 2013; Burgess, 2009) with Sule and Stern (2012) arguing that remittances do have the expected positive impact on diaspora bonds. Yet almost 90 years after they were first used, only two African countries (Ethiopia and Kenya) have issued diaspora bonds in spite of an estimated 40 million Africans living outside the continent and saving up to an estimated $53 billion in their destination countries each year (Plaza & Ratha, 2006). Ghana, Cape Verde, Uganda, Niger and Kenya have been planning to issue their own for some time now.

By 2009, remittances to developing countries (over $300 billion) dwarfed official development assistance ($120 billion) and portfolio investment ($85 billion) and nearly surpassed foreign direct investment ($359 billion). In Sub-Saharan Africa, the growth rate of remittance flows to the region is projected to rise to 3.3 and 3.7 percent in 2016 and 2017 respectively (World Bank, 2015) (see Fig. 2). Similarly, (Kayode-Anglade & Spio-Garbrah, 2012) argue that remittances are the largest source of net foreign inflows after foreign direct investment (FDI), ranking higher than ODA but the source of remittances, although relatively diverse, is primarily industrialized nations.

Figure 2. Estimates and projections for remittance flows to Sub-Saharan Africa

Source: Data from World Bank.
However, the African experience with diaspora bonds has shown mixed results, which could be explained in part by political and governance issues that the diaspora may have with the bond issuing governments as argued by Fatunla (2015) and Burgess and Perez-Armendafiz (2013).

The issuance of Ethiopia’s Millennium Corporate bonds to raise funds for the Ethiopian Electric Power Corporation (EEPCO) did not meet the expectations, as sales were slow during the first months of offering despite intensive efforts to promote them. Yet, the lessons learnt from this issuance were made use of in 2011 when Ethiopia issued its second diaspora bond, “Renaissance Dam Bond” to fund the generation of over 5,000 Megawatts of electricity. The lessons learnt resulted in a minimum denomination of USD 50 thereby enabling many Ethiopians to afford them; making them transferable to up to three people; making them valuable as collateral in Ethiopia; and having the Commercial Bank of Ethiopia cover any remittance fees associated with the purchase of the bonds (Plaza & Ratha, 2011).

Even though diaspora bonds are not among the traditional sources of development finance for many countries, a good number have created specialized structures or have taken initiatives to engage the diaspora in national development (Note 4) AfDB (2012). Moreover, an African Union Act underscores the importance of the Diaspora as a component of the AU and its processes, and regards the African Diaspora as the “sixth region” in addition to the existing Regional Economic Communities. All such initiatives are good beginnings but they have to be followed by issuances of diaspora bonds to help overcome development challenges such as infrastructure deficits. The lessons derived from Ethiopia should encourage other African countries to move to the next step of considering how best they can leverage this financing instrument.

3.2 Carbon Sequestration and Trading

Another source of development finance that is not traditional in Africa is carbon trading. A market-based mechanism that the Kyoto Protocol encouraged to facilitate such trading is the Clean Development Mechanism (CDM) (UNFCCC, 2008). This was reaffirmed at the COP 21 meeting in Paris in December 2015 during which the provisions for linking carbon markets, the establishment of a new net mitigation mechanism and a framework for non-market approaches to sustainable development was one outcome (Carbon market watch, 2015).

The CDM facilitates project-based carbon trading between developed and developing countries by allowing carbon projects to be undertaken in developing countries that reduce or avoid the emissions of greenhouse gases into the atmosphere. For developing countries, it has the potential to add to their revenue streams and development finance. Sireh-Jallow (2008) argued that carbon trading could be a potential non-traditional source of development finance for Sierra Leone to consider and empirically, the UNDP (2011) finds that Ethiopia could mobilize up to USD 500 million a year from sources that are not traditional to it, such as carbon trading and tourism, among others. Out of the amount, Sireh-Jallow (2010) argues that USD 140 million could come from carbon trading if certain policy intervention measures are put in place.

However, carbon trading has its passionate opponents and proponents. The proponents argue that the carbon market is the most tangible result of efforts to mitigate climate changes. Opponents, on the other hand, perceive it as immoral. They argue that developed economies should not be allowed to pay their way through polluting. Nevertheless, carbon trading is a source of development finance and policy makers should make an informed decision on how or how not to exploit it.

The UNFCCC argues that, by March 2016, the CDM has been able to reduce greenhouse emissions manifested by the issuance of more than 1.6 billion certified emission reductions (CERs) (each equivalent to one ton of carbon dioxide) in some 8000 projects in 107 countries (UNFCCC, 2016). In spite of all these facts, the CDM has, to date, largely overlooked sub-Saharan Africa. The region currently accounts for little more than 6% of worldwide CDM projects and 2.2% of the carbon credits (Certified Emissions Reductions (CERs)) issued by 8 September 2016. This is so despite the tremendous potential that Africa has in this regard, as articulated by the African Development Bank during its preparations for COP 21. The Bank argued that Africa has gigantic atmospheric vacuum cleaners that are its natural tropical forests - 650 million hectares of untouched forest, almost a fifth of the world’s stock. These carbon ‘sinks’ can suck in 1.2 billion tons of carbon dioxide per year – about half the carbon dioxide emissions from all the homes in the United States (AfDB, 2015). It went on to argue that it is doable even under the threat of deforestation and forest degradation.

The Institute for Security Studies explains that one reason for Africa’s poor performance with the CDM is that, since large proportions of electricity in Africa are derived from hydro sources across many countries, it makes it harder to rely on ‘investment’ through CDM because carbon credits would not be awarded for proposed clean energy sources (ISS, 2011). It also explains that the high proportion of hydro power resources in a country’s electricity mix means that the emissions factor (EF) is relatively low and a low emissions factor means modest
corresponding Certified Emissions Reductions (CERs); hence, less money. It goes on to argue that given the choice, an investor seeking high returns is likely to pick less risky but dirtier pastures elsewhere in the South, where higher and quicker returns are guaranteed. It can therefore be seen that African countries are not rewarded for playing clean. This clean record should be an asset during international negotiations on climate change.

3.3 Renewable Energy Fiscal Space

Africa is home to enormous renewable energy resources that have a great potential to increase the fiscal space. The AfDB (2015) contends that the potential is breathtaking as the continent can source further 11 terawatts of solar energy, 350 gigawatts of hydropower, 110 gigawatts of wind power, and 15 gigawatts of geothermal potential. The power thus generated, if fully used and responsibly managed, cannot just solve Africa’s own energy problems, but those of other countries near and far, too. Hence, building its capacity to harness and sell renewable energy to the rest of the world could create significant fiscal space for many African countries - a nontraditional one too. With the right policy interventions, African policymakers could transform their economies into leaders of the renewable energy industry of the future. This may seem remote today, especially when the amount of energy produced by the entire African continent is equal to that produced by Spain alone (Africa Progress Panel, 2015). However, it is possible through dynamic competitiveness as espoused by (Sireh-Jallow & Ba, 2014).

3.4 Islamic Finance

Islamic finance has become one of the fastest-growing segments of the global financial system and countries such as Malaysia, Indonesia and Bahrain have leveraged the Islamic finance instrument, sukuk, to finance development. The assets controlled by authentic Islamic banks along with Islamic subsidiaries and “windows” of conventional banks increased four-fold to US$ 400 billion between 2000 and 2008 (Chin et al., 2008). Furthermore, Beal, Damisch, Zakrzewski, and Zurkiya (2011) argue that in 2010, there were more than 300 Islamic financial institutions operating in more than 75 countries.

Even though the number of African countries issuing sukuk to finance infrastructure development has increased significantly in the last two years, there is still a considerable number that are yet to embrace them. The Gambia and Sudan have issued local currency short-term domestic sukuk for many years now (Sy, 2013). However, in the international markets, Senegal issued the first sukuk in June 2014 for USD 168 million with a four-year maturity followed by three-month ones by South Africa for USD 500 million with a 5.5-year maturity. Since then, Cote d’Ivoire, (Note 5) Togo (Note 6) and Nigeria (Note 7) have followed suit. Ghana, Cape Verde, Uganda, Niger and Kenya have expressed interest in exploiting them. This leaves about 37 African countries yet to leverage the instrument to mobilize development finance in spite of the opportunities that exist. These countries may be encouraged to know that investors from all over the world subscribed to the Indonesian sukuk in 2010. The United States and European investors subscribed to 19% and 11% respectively, which together are just under a third of the total sukuk issued by the country, with the Middle East taking up 30% and the remaining 40% taken up by Asian investors (IIFM 2011). In terms of investor class, Funds took up 45% of the sukuk, while Banks took up 37%. Retailers 14% and the remaining 4% went to Insurance and Pension funds. Consequently, with the right policy environment, Islamic finance instruments such as sukuk could offer African countries another potential non-traditional source of development finance.

3.5 Tourism

Tourism is one source of development finance that is traditional to all African countries but not fully exploited as in other parts of the world. Globally in 2014, tourism accounted for 9% of global GDP, created 1 in every 11 jobs, amounted to USD 1.5 trillion in exports and was 60% of world exports and 30% of service exports (UNWTO, 2015). UNWTO has projected international tourist arrivals worldwide to increase by an average annual growth rate of 3.3% from 2010 to reach 1.8 billion in 2030. Moreover, within this period, arrivals in emerging destinations (4.4% per annum) are expected to increase at twice the rate of those in developed economies (2.2% per annum). In 2016, the projection is optimistically estimated at between 3.5 and 4.5 percent per annum. About 1.2 billion international tourist arrivals (overnight visitors) are estimated for 2016, which represents 50 million more arrivals than in 2015. However, international tourism arrivals in Africa are not only expected to grow the least (between 2 to 5%) in 2016, UNWTO projects that the region will continue to receive the least number of international tourist arrivals in 2020 (6%) and 2030 (7%). The fact that the sector brought in USD 1.5 trillion in 2014 shows its fiscal space creating potential, which African countries should exploit.

One of the drivers of the tourism sector is the availability of attractions for tourists and historical and cultural heritage sites are very popular among tourists the world over. One such category is the UNESCO world heritage sites of which, 1,023 are registered with the Commission (UNESCO 2016) in late 2015 (Note 8). Forty-eight
percent of these are in Europe, 23% in Asia and the Pacific, 13% in Latin America, 9% in Africa and 8% in Middle East. A strong correlation (correlation coefficient of 0.9922) exist between the tourist arrivals and the UNESCO World heritage sites. The higher the number of sites in a region, the higher the number of international tourist arrivals they have, especially in America, Europe, Asia and Pacific.

The low share of African heritage sites registered with UNESCO points to considerable room for improvement thereby offering a tremendous opportunity to exploit. Coupled with the high correlation, the identification and registration of more sites could have the potential to increase the fiscal space from tourism. Consequently, African countries should identify all the potential cultural and heritage sites they have in their countries and work with UNESCO to register them. Equally importantly, such sites have to feature prominently in their tourism promotion strategy.

Tourism unfortunately is one of those sectors that have a high tendency of exhibiting a *silo-characteristic*, thriving very well without any forward or backward linkages to the rest of the economy. Hotels in Africa are known to import even eggs from abroad despite domestic production. It is therefore necessary for policy makers to develop tourism policies and strategies that ensure linkages to all the sectors of the economy.

All said tourism, like any other fiscal space creating source, is highly dependent on the subjective decisions of people and prone to be adversely affected by the slightest of adverse occurrences. Negative travel advisories on security or health issues are all it takes to effect massive cancellations. It is therefore important that a country does not exclusively depend on tourism for all its development finance needs. The watchword is revenue diversification; tourism should be one of many sources and if it is not a traditional source in the country, it should be a non-traditional source, especially if tourism assets abound.

4. Conclusion

African countries have to own their development and therefore, like other developed countries of the world, must control the financing that funds their development. Therefore, the full potential of their economies to mobilize such financing must be nurtured and leveraged. The countries have to use fiscal policies and frameworks to make sure that, in the medium to long term, they can leverage all the sources of development finance that have the potential to increase the fiscal space, especially if they are non-traditional. This will have to go with attendant policy interventions that could include some upfront expenditure to create the environment for more fiscal space in the medium to long term. Each country should strive for revenue diversification to ensure sustainable flow of development finance.

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References


Notes

Note 1. The SDGs are the seventeen development goals the international development community held in September 2016 at the UN Summit set to achieve by 2030. The SDGs are a replacement of the MDGs.

Note 2. The UNMP methodology was used on the MDGs but to the best of the author’s knowledge has not been used on the SDGs. In lieu of this, the needs of the MDGs are computed and used as a conservative estimate for the corresponding needs of the more ambitious SDGs.

Note 3. These include global environmental taxes (e.g. carbon trading), the International Finance Facility (IFF), currency transaction taxes (Tobin tax), Global Lottery and Global Premium Bonds, additional Special Drawing Rights (SDRs) for development, Advance Market Commitments (AMC) for vaccines, amongst others.

Note 4. Burundi, Sierra Leone, Democratic Republic of Congo, Nigeria and The Gambia

Note 5. Cote d’Ivoire has offered two, one in January 2016 and the other in August 2016, each for CFA 150 billion with yields of 5 and 6.5 percent per annum respectively.

Note 6. Togo’s sukuk is valued at CFA 150 billion at 6.5% with a 10-year maturity.

Note 7. In Nigeria, Osun State issued a USD 62 million sukuk to build public schools.

Note 8. As of December 7, 2016, the number of registered heritage sites have increased to 1,052 and of this 29 more that were added since, two are on the African continent - in Chad and Sudan.

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