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Unlocking Africa's $100 billion public-finance opportunity

By Acha Leke, Yaw Agyenim-Boateng, Francisco Mendes, and Aurelien Vincent

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Although Africa remains the world's poorest continent, many of its governments have made impressive progress in fostering development and improving people's lives. For example, Africa's spending on infrastructure has doubled to around $80 billion a year in the past decade, while multiple reforms have improved African countries' ease-of-doing-business ratings. Thanks in part to these steps, the continent's combined GDP has tripled since the turn of the century. Investments in health systems have delivered significant gains—including a 50 percent reduction in infant mortality rates since 1990. And in education, the average time African children spend in school has nearly doubled since 1990, contributing to raising the continent's youth literacy rate to 70 percent[1].

Will this progress be sustained or stalled in the decade ahead? In large part, the answer will boil down to finance. Africa today faces a perfect storm of a slowdown in growth, depressed commodity prices, stagnant tax revenues, and rising public debt. African governments' combined budget deficits exceeded $100 billion in 2018, equivalent to almost 5 percent of GDP—double the level in 2010. Closing the significant remaining infrastructure gap will cost another $100 billion per year[2]. Without appropriate action, many governments will face mounting fiscal pressure and find their ability to invest severely constrained.

Yet African governments have more scope than is often assumed to mobilize domestic resources for their own development and improve efficiencies in public spending. Several pioneering governments have already achieved big improvements in revenue collection through tax-system reforms, while others have delivered significant budgetary savings in areas such as public procurement and capital expenditure. McKinsey's analysis shows that similar public-finance reforms, if scaled up across the continent, could close the entire fiscal deficit—or the $100 billion infrastructure-spending gap—within a few years.

In this paper, we highlight the public-finance challenges facing Africa today, and we assess the opportunities for African governments to improve both revenue collection and spending efficiency. We also point to the far-reaching transformation that many will need to undertake if they are to deliver on those opportunities. It is clear that Africa's fiscal challenges, while serious, can be resolved through levers that are available to most countries. Africa's governments have the power to navigate today's headwinds and steer the continent towards continued rapid growth and social development.

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[1] Africa's Business Revolution: *How to Succeed in the World's Next Big Growth Market*, Harvard Business Review Press, 2018
[2] For further discussion on Africa's infrastructure gap, see *Bridging infrastructure gaps: Has the world made progress?*, McKinsey Global Institute, October 2017

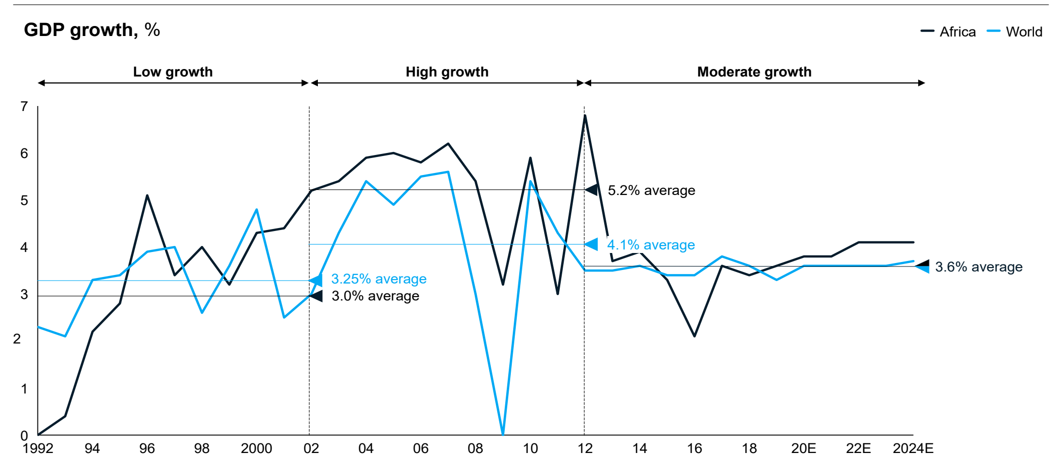
A perfect storm: Africa's public-finance challenges

A long-term view reminds us that Africa's economic fortunes are on the rise. Real GDP growth, which barely topped 2 percent a year on average during the 1980s and 1990s, leaped ahead to 5.2 percent in 2000–2010, making Africa the world's second-fastest-growing region after emerging Asia. In the late 1990s, private capital flows to Africa (including foreign direct investment, equity, and debt) overtook aid inflows and remittances for the first time in decades. Rising productivity and investment reflected the increasing diversification of Africa's economies away from resources exports[3].

After this heady decade, however, Africa's growth slowed sharply—to an annual rate of 3.3 percent between 2010 and 2015. This was prompted by the twin shocks of the Arab Spring, which halted growth altogether in Egypt, Libya, and Tunisia; and the collapse of oil prices, which caused growth to fall sharply in oil-exporting countries including Algeria, Angola, and Nigeria. The recovery from that slowdown is still underway: Africa's GDP growth is forecast to reach 3.8 percent in 2022 and 4.1 percent in 2024[4]. Although key African economies such as Ethiopia and Ghana are now among the world's fastest-growing, the continent overall will feel the effects of slower growth for some time to come (Exhibit 1).

Exhibit 1

Africa's GDP Growth



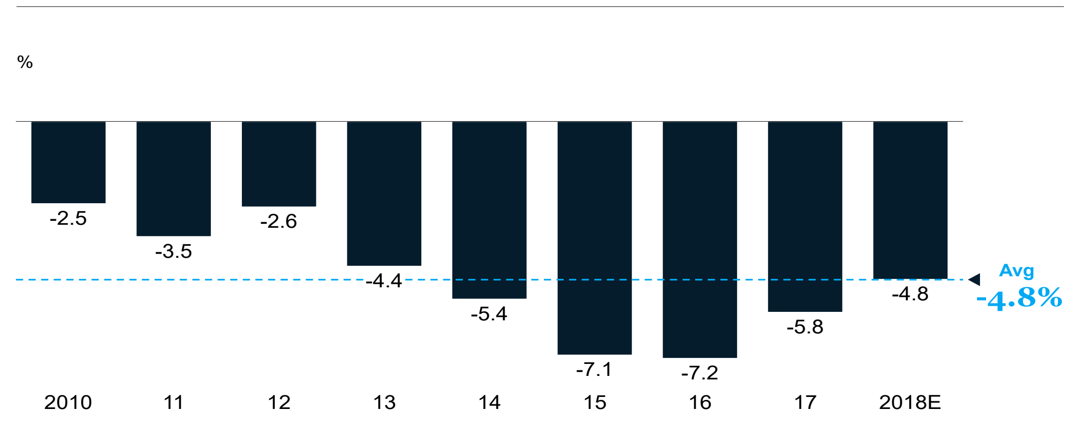
Source: IMF Data mapper

[3] Acha Leke et al, *op cit*
[4] Figures drawn from IMF data

The economic slowdown has been matched by a sharp rise in fiscal deficits. The average fiscal deficit, which stood at 2.5 percent in 2010, ballooned to over 7 percent in 2015. Although the picture has since improved, deficits remained high at 4.8 percent in 2018 (Exhibit 2). That reflects the fact that growth in public expenditure has consistently outpaced revenues in recent years. In 2018, Africa's public spending amounted to $555 billion, but government revenues came in at only $443 billion—resulting in a fiscal deficit of $112 billion[5].

Exhibit 2

Africa's fiscal deficit



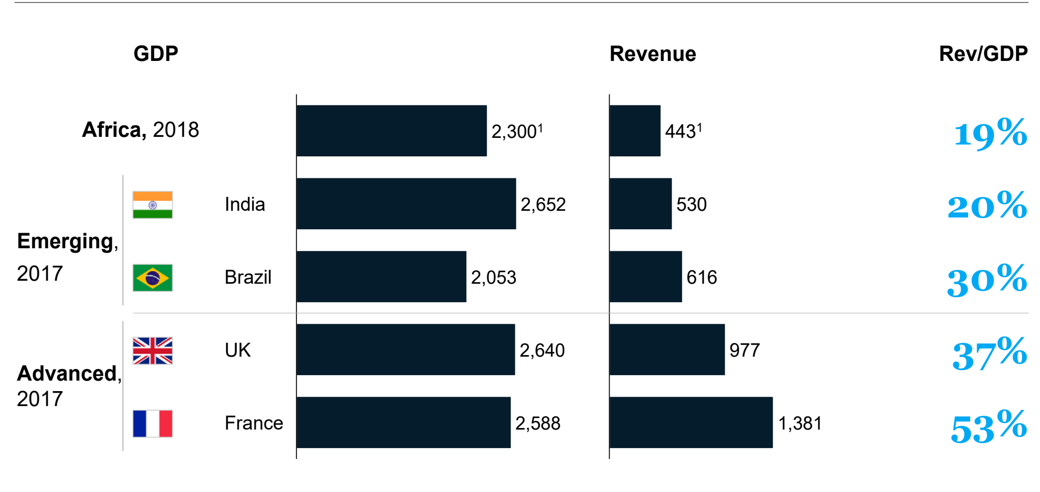
Source: African Development Bank

African countries' $443 billion government-revenue take in 2018 represented only 19 percent of the continent's GDP, down from 23 percent in 2010[6]. That decline reflects the impact of declining revenues from natural resources—including oil, which saw a sharp fall in prices in 2013-2014 and is still far from earlier peaks. As we discuss below, some countries collect more than others; nonetheless, Africa's overall low ratio of public revenues to GDP makes it a global outlier. By contrast, the ratio of public revenues to GDP in most non-African emerging countries stands at between 25 percent and 35 percent—for example, 30 percent in Brazil. In the majority of advanced countries, the ratio stands at between 35 percent and 55 percent—for example, 37 percent in the UK and 53 percent in France. These comparisons make it clear that Africa as a whole is not "monetizing" its economy as much as it could (Exhibit 3).

[5] Figures based on McKinsey analysis and IMF data
[6] These figures are projected from IMF data and national publications.

Exhibit 3

Africa has a less 'monetized' economy than other key markets



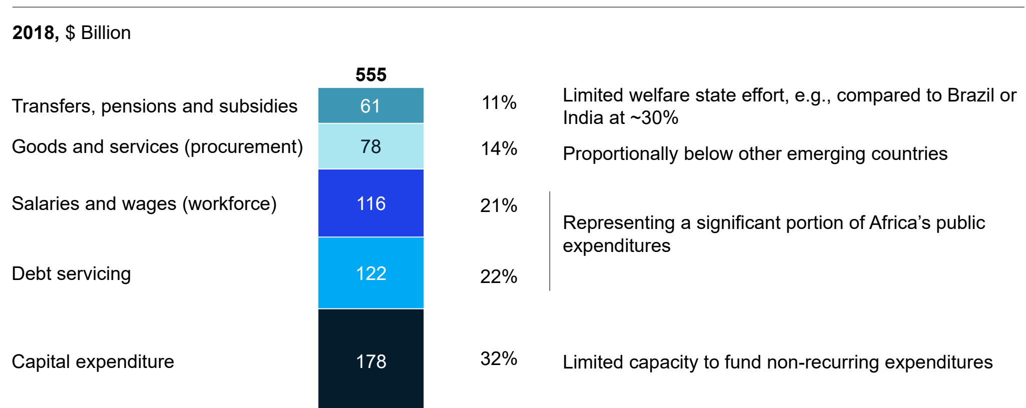
Source: IMF, National publications, African Development Bank

1 2018 figures

Just as African governments have faced challenges in revenue collection, there has been upward pressure on public spending, which has outstripped revenue growth. Debt-servicing costs constitute 22 percent of that expenditure. Public-sector salaries and wages make up 21 percent of government spending, a higher proportion than in other emerging regions. Conversely, Africa's government budgets reflect a relatively low contribution to capital expenditure (32 percent) and pensions and subsidies (11 percent) compared to peer nations (Exhibit 4).

Exhibit 4

Aggregate African government expenditures

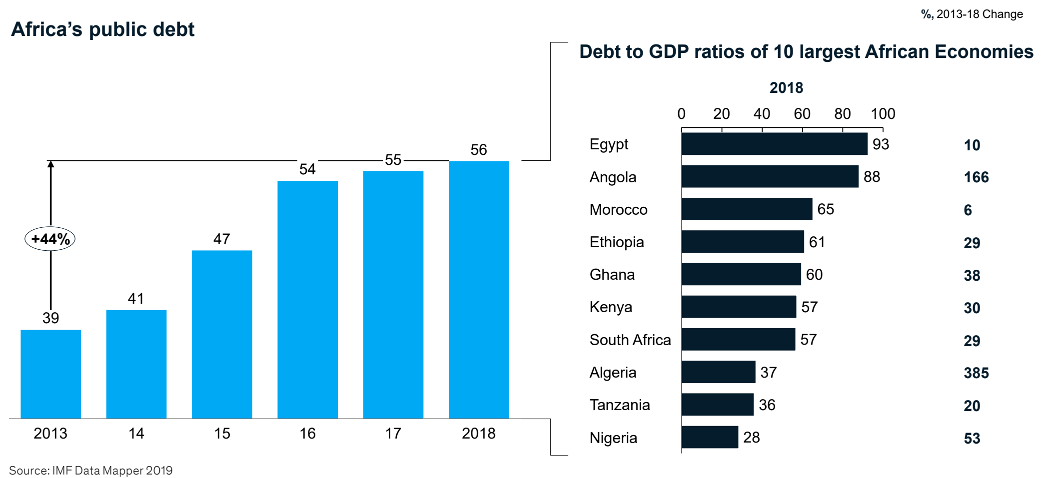


Source: McKinsey analysis, African Development Bank

African countries' revenue and expenditure challenges, along with the accompanying fiscal deficits, have inevitably resulted in a growing public-debt burden. In 2018, Africa's cumulative public debt stood at a historical high of 58 percent of GDP—up from 40 percent five years previously. That continent-wide picture has been reflected in rising debt levels in nearly all of Africa's largest economies (Exhibit 5).

Exhibit 5

Change in indebtedness of African economies

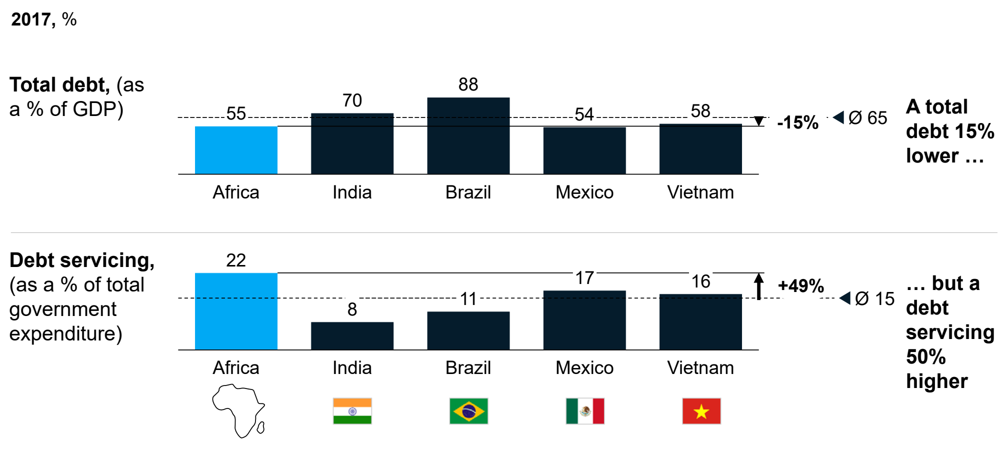


Source: IMF Data Mapper 2019

Nonetheless, Africa's debt-to-GDP ratio is still considerably lower than that of advanced economies such as Japan (where it stands at 235 percent), France (99 percent) and the UK (87 percent). It is also lower than that of many emerging countries. Yet Africa's debt-servicing as a ratio of public expenditures is significantly higher than that of major emerging countries such as Brazil, India, Mexico and Vietnam owing to the high cost of African debt. That underlines the fact that Africa has more of a debt-servicing challenge than a debt problem (Exhibit 6).

Exhibit 6

Africa's debt and debt servicing vs. selected emerging countries



Source: International Monetary Fund (IMF), World Bank

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Africa's $100 billion public-finance improvement opportunity

Given the sobering numbers set out thus far, it is urgent for African governments to look at how they might strengthen their public finances. Most countries have considerable scope both to increase revenues through tax modernization, and to improve efficiencies in public spending. Some African countries have already made real progress in these public-finance reforms, delivering billions of dollars in additional revenues, along with significant savings. In McKinsey's experience of working with several African countries on such reforms over the past five years, it has seen each country deliver annual revenue improvements of between $1 billion and $5 billion, or budgetary savings of at least 5 percent of total budget, or both.

That points to the fact that the solutions to Africa's public-finance challenges do not need to be invented from scratch: many are already proven. If scaled up across the continent, such solutions could eliminate Africa's entire budget deficit. Alternatively, these reforms could unlock sufficient funding to close Africa's $100 billion infrastructure-spending gap. Moreover, such reforms could be enacted relatively quickly. They could generate substantial new revenues and savings within three years—without increasing tax rates or reducing the impact of government spending in critical areas such as education and health. But as we discuss in the next section, many African governments will need to face up to deep-seated barriers to implementation if they are to deliver this prize. That will require a true transformation in approaches to public finance.

McKinsey's analysis shows that, launched at scale, efforts to improve tax-collection performance and public-spending efficiencies have the potential to deliver recurring annual impact of between $85 billion and $125 billion a year for Africa's governments (Exhibit 7).

Programs to enhance tax and tariff-collection performance have the potential to deliver between $45 billion and $65 billion in additional annual tax and customs collection within three years. That translates into additional revenues of between 2 percent and 3 percent of GDP—without changes to tax rates or trade tariffs. In addition, programs to improve public-spending efficiency have the potential to deliver between $40 billion and $60 billion a year from expense efficiencies, such as implementing leaner capital expenditure practices, revamping procurement procedures and eliminating "ghost" workers. Those savings represent between 8 percent and 12 percent of the aggregate budgets of African governments.

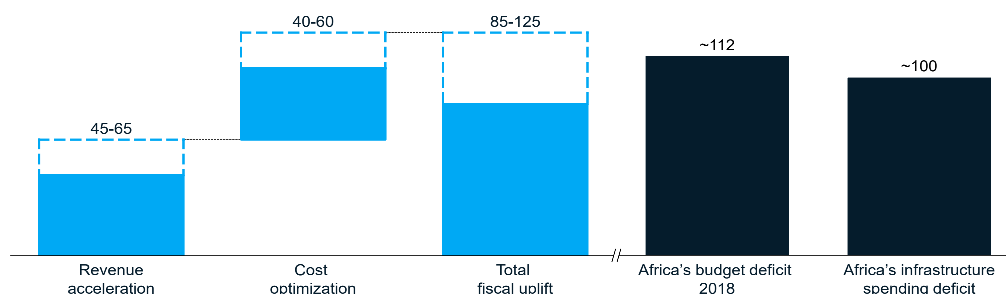
$1-5 billion per country

in additional annual revenue per country, delivered through recent tax-system reforms in Africa

Exhibit 7

Africa's public fiscal transformation opportunity

Annual public revenue increase and expense savings potential[1], 2017, $ bn



1 Before accounting for annual GDP growth; Resource rents are excluded from tax analysis

Source: IMF country desks (AFR Economic Outlook and Fiscal Monitor reports); Africa Growth Initiative at Brookings; ICTD / UNU-WIDER Government Revenue Dataset; World Bank WDI indicators; McKinsey Global Institute analysis; Country budgets; McKinsey analysis

Mobilizing domestic resources for development: Africa's revenue opportunity

Today, tax collection levels are highly uneven across the African continent. For instance, South Africa's tax-to-GDP ratio stood at 25 percent in 2018, and Kenya's at 16 percent—but countries such as Ethiopia and Ghana gathered only about 11 percent of GDP in taxes. In oil-exporting nations such as Nigeria, tax collection excluding resource rents still makes up less than 10 percent of GDP, despite bold efforts to improve tax administration in recent years (Exhibit 8). That wide variance in tax-to-GDP ratios points to a significant opportunity to increase revenues in many African countries.

Research by the McKinsey Global Institute (MGI)—as well as by institutions such as the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD)—has highlighted several factors driving Africa's generally low tax rates. Government revenue authorities typically have limited data on the number of potential taxpayers, lack effective tracking tools, and have gaps in capabilities and resources. In addition, tax collection processes are often complex and burdensome. The time required by firms to pay their tax is longer in Africa than in regions such as East Asia and OECD countries, although there are exceptions to this general rule including Kenya, Morocco, and South Africa[7].

MGI estimated that African governments could boost tax revenue substantially if they were to eliminate non-compliance including fraud, neglect, error, and non-payment. The opportunities include reducing informality to increase registration of taxpayers, and strengthening the administration of tax systems by improving data collection, using data to drive risk-based compliance, and better enforcement.

Such steps need to form part of an integrated, comprehensive transformation program that embraces the full tax-administration value chain, from registration through to debt collection (Exhibit 9). In customs, likewise, an end-to-end transformation may be required (Exhibit 10). There are significant improvement opportunities at each stage of these value chains.

[7] *Lions on the Move II: Realizing the potential of Africa's economies,* McKinsey Global Institute, August 2016

Delivering such a transformation also requires strong leadership and disciplined execution. The experience of successful tax modernization programs in Africa and elsewhere in the world points to three distinct components of such a transformation:

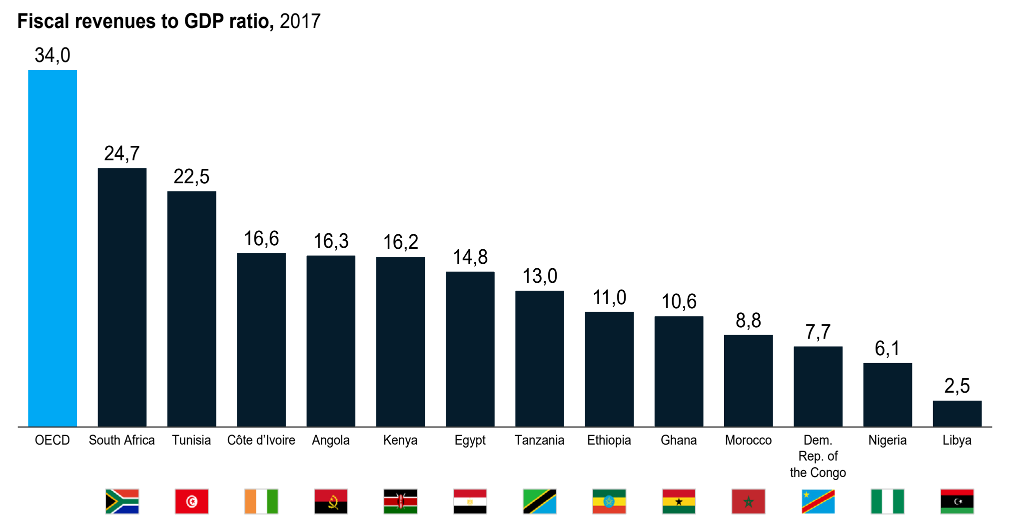
— **Improving the tax system to strengthen long-term sustainability.** One key step is to review and close the loopholes in corporate income tax—including taking steps to prevent tax-base erosion and profit shifting by companies from one jurisdiction to another. Another key step is the simplification and improvement of VAT regimes—including reducing exemptions and launching electronic invoice programs. Other levers include designing specific tax regimes for micro-activity and informal businesses, and redesigning exemption regimes to ensure that they actually drive investment and economic development.

— **Reforming tax and customs administration to improve enforcement and collections.** Key steps include ramping up inspections and audit processes and capabilities, including leveraging advanced-analytics techniques and third-party data—for example, from banks, utilities, and retailers. Governments and tax authorities also have the scope to make debt-collection processes more stringent.

— **Improving compliance.** Levers available include launching or strengthening initiatives to drive registration of businesses and individuals. Authorities can also reduce barriers to compliance, for example by enabling greater use of remote payments and pre-filing—and, where appropriate, by allowing defaulting taxpayers a "clean start". Longer-term levers include the launch or strengthening of taxpayer education programs delivered through mass media.

Exhibit 8

Fiscal revenues to GDP ratio across the largest economies in Africa[1]

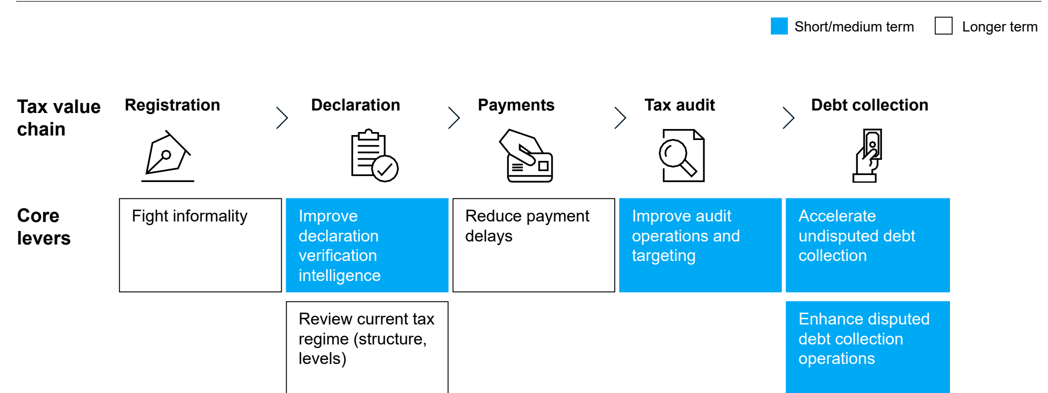


1 Non-exhaustive list

Source: Economic Commission for Africa – African Statistical Yearbook

Exhibit 9

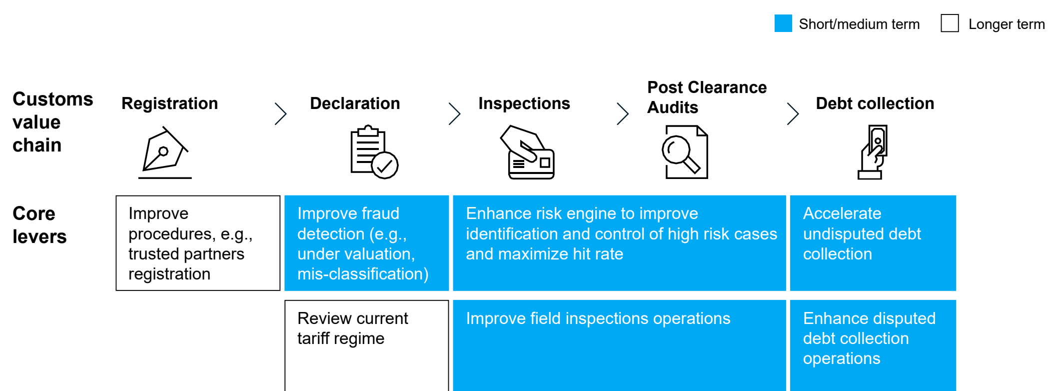
Africa's tax revenue acceleration opportunity



Source: McKinsey analysis

Exhibit 10

Africa's customs revenue acceleration opportunity



Source: McKinsey analysis

Several of these levers can deliver impact in a space of months, not years—as the experience of a West African country shows. In just six months, it increased tax and customs revenues by 23 percent—and nearly doubled the tax compliance rate while improving debt recovery from defaulting taxpayers five-fold. The country achieved these results by redesigning customs processes with a focus on compliance; and creating a centralized task force focused on debt collection.

A notable driver of this country's rapid improvements was its decision to set up an "audit factory". This new unit strengthened inspection capabilities and introduced an audit "risk engine" that helped prioritize high-value audits of both company and individual taxpayers. Before the country's tax transformation, only the 200 largest taxpayers had been regularly subjected to tax auditing, and there were widespread discrepancies in tax auditing procedures. To address those gaps, the audit factory put in place a rigorous approach to standardize and extend auditing processes, with leadership and coaching to set weekly goals and help team leaders achieve them. The result was a fifteen-fold increase in the number of tax notices resulting from audits, from 165 in the year prior to the program launch, to nearly 2,500 in the third year of the program.

Many countries also have the opportunity to launch more broad-based revenue-improvement efforts—and again, there are powerful existing examples to learn from. For instance, Angola launched a five-year tax transformation program between 2011 and 2015 that resulted in an 80 percent increase in non-oil revenue. The country used a combination of both structural reforms, including a redesigned tax code, and a massive improvement in tax and customs collection and enforcement. To achieve the latter, the country revamped its tax administration, deployed advanced analytics tools to maximize information sharing, created digitized tax processes, and implemented a comprehensive cultural transformation across the government.

In just six months, a West African country increased tax and customs revenues by 23 percent.

Delivering more for less: Africa's public-spending efficiency opportunity

On the expenses side, African governments have opportunities to deliver substantial savings in most of the major categories of public expenditure (Exhibit 11). In our experience, this is generally an opportunity that is overlooked. Those opposed to notices include the following:

- **Transfers, subventions and subsidies.** Potential steps include leveraging digital technologies to create transparency on how subsidies are applied, and thus eliminate leakage and reduce overheads. Many governments also have scope to reduce costs of transfers based on a reassessment of beneficiary agencies' true financial needs.

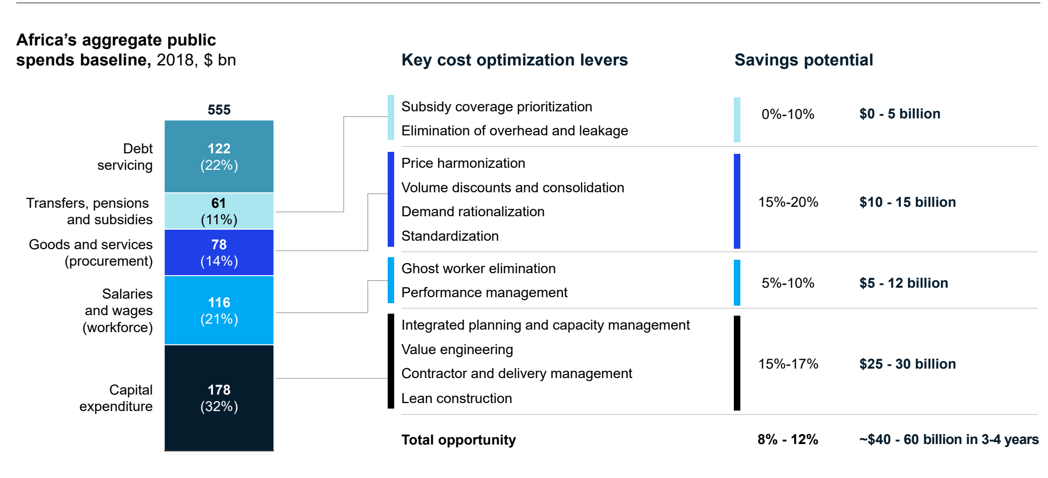
- **Procurement.** Governments can undertake targeted initiatives including the centralization and harmonization of procurement processes for common categories of goods or services procured by government entities. Another opportunity is to define a price index allowing for the selection and enforcement of a reference price by type of goods.

- **Workforce.** Governments have several levers available to them to reduce workforce costs without resorting to reducing headcount. One is to eliminate "ghost workers"—salaries paid for non-existent roles, a problem common to many African countries—by bringing transparency to the government payroll. Another lever is the implementation of revamped performance-management practices.

- **Capital expenditure.** Governments can improve capital expenditure (capex) planning, including through enhancing planning and prioritization processes. And they can strengthen delivery initiatives—for example, through monitoring and auditing of contractors and systematic implementation of legal contractual safeguards such as the enforcement of performance contracts.

Exhibit 11

Africa's public expenditure savings opportunity



Source: IMF; Country budget documents; McKinsey analysis

Several African countries have already delivered significant efficiencies by applying these levers. For example, a West African country achieved a public expenditure efficiency program that led to a 5 percent reduction in absolute government expenditure in just 18 months. Key efforts to achieve that result included the following:

— **Capex planning and scrubbing initiatives.** These included technical counter-expertise interventions for major projects to reduce time and costs. Steps were also taken to reduce operations and maintenance costs, for example through the implementation of multiyear road-maintenance contracts. To ensure the improvements were sustained, the government implemented a new capex review procedure that allowed for systematic investment capex optimization.

— **Reduction in costs of goods and services.** The government introduced a centralized, standardized and streamlined procurement function and associated processes, with a focus on real estate, vehicles and travel expenses. In the vehicles category, for example, it centralized vehicle purchasing; negotiated longer-term, lower-cost contracts for fuel supply and repairs and maintenance; introduced vehicle sharing; and sold off under-used vehicles.

— **Redesigned investment framework.** This removed unnecessary exemptions and implemented targeted controls to review the enforcement of tax exemptions. The new controls helped uncover numerous fraudulent situations, including companies benefiting from tax exemptions years after the exemption period had expired—and applying the exemptions to a wider scope of goods and services than was authorized by the law.

Other countries have delivered substantial impact in targeted categories of public spending by leveraging data and analytics. For example, Nigeria's federal government launched the Integrated Payroll and Personnel Information System (IPPIS) in 2016 to automate the payroll of civil servants and eliminate ghost workers. In one instance of the impact of this change, the government was able to eliminate more than 80,000 ghost officers from the Nigeria Police Force after integrating the force's payroll into IPPIS[8].

This example is a reminder that corruption and fraud remain a serious drain on Africa's public finances—and that governments need to take bold steps, including through technology-enabled solutions, to tackle this problem. The African Union has estimated that as much as $150 billion is lost to corruption every year across the continent, in the form both of losses from the public purse and bribes paid by individuals and businesses.

5%

reduction in government expenditure delivered by a West African country in 18 months

[8] Victor Ekwealor, *Unified database uncovers over 80,000 ghost workers in the Nigeria Police Force*, Techpoint.africa, March 27, 2018, https://techpoint.africa/2018/03/27/nigerian-police-ghost-workers/

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From opportunity to action: designing and delivering a major fiscal transformation program

The lessons learnt from successful public-finance transformations in Africa show that solutions are widely known, but that implementation can be difficult. These implementation hurdles include vested interests, silos in organizations, a lack of focus, and gaps in capabilities. We have seen governments deploy six components to overcome these barriers:

1. The right leaders in place for the transformation and across relevant institutions—not only must these leaders have the right technical capabilities, they also need to inspire others and serve as role models for the entire organization.
2. Strong political will and discipline throughout the transformation—including active championing of the effort by political leaders, made visible across the government.
3. Active engagement of key stakeholders, including the private sector and development partners.
4. A compelling change story communicated throughout the public service to foster understanding of the purpose of the transformation and conviction that the change is beneficial and meaningful.
5. Balanced focus on aggressive revenue growth and on cost control—with sustained pressure to maximize impact on both sides of the equation.
6. Technology as a key enabler of the transformation: digitization allows governments to increase transparency radically, and it enables better decision-making.

Meaningful public-finance transformations typically require action by multiple departments, agencies, ministries, and other stakeholders. These entities are often asked to move faster than they are accustomed to moving, collaborate in joint teams and initiatives, and experiment with bold new approaches.

Meaningful public-finance transformations require action by multiple departments, agencies, ministries, and other stakeholders.

To tackle these challenges and ensure effective coordination, several governments manage transformation via newly established “delivery units”—small, agile, cross-functional teams comprising exceptional personnel who have direct access to top government leadership and are fully dedicated to driving delivery. While some units are established for just a few years to manage the delivery of specific programs, others have more permanent roles spanning multiple administrations. Successful delivery units have been led by a senior official or business executive with a peer-like relationship with ministers. They have also been staffed by talented people—from either the public or the private sector—who are effective problem solvers, communicators, and influencers.

An example is the Prime Minister’s delivery unit team in an East Africa country, set up to oversee the implementation of improvement initiatives in both tax policy and tax administration. It supports the Prime Minister with high quality data and reporting transparency, enabling efficient steering of the public-finance transformation and rapid debottlenecking of barriers to implementation. The team has delivered rapid impact, including a $200 million increase in tax revenue in the first year of its existence.

A McKinsey survey of nearly 3,000 government officials involved in transformations found that efforts that were centrally coordinated by a dedicated team were twice as likely to be successful than those that were delivered through standard government organizations[9]. But the key challenge for leaders of public finance transformations is not merely to set up a central coordinating unit—it is to make sure this unit is effective.

By way of an analogy, consider the difference between a music critic and an orchestra conductor. Many central program-management offices are more akin to the critic: they carefully observe and assess a performance, and after the fact they report its successes and flaws in a standardized template. Truly effective delivery units, on the other hand, are like conductors: they actively coach the players, providing real-time feedback that constantly improves the performance[10]. These units are designed and staffed to share responsibility for delivery and impact.

African governments face serious fiscal challenges, but they also have tremendous opportunities—realizable in the near term—to reform public finances. With sufficient commitment to transformation, governments can create new headroom to pursue spending priorities without threatening fiscal sustainability.

Given the major funding needs to meet the continent’s development goals, the time to act is now. Finance ministers who take the lead can oversee a robust assessment of their countries’ opportunities to increase tax and customs revenue and improve the efficiency of public spending. And they can then design an effective delivery machine to translate this potential into tangible, sustainable gains.

[9] *Delivering for citizens: How to triple the success rate of government transformations,* McKinsey Center for Government, May 2018

[10] For more on this topic, see *Reframe to Reform: Putting people at the center of government transformations*, McKinsey Center for Government, January 2019

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