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Politics of Domestic Resource Mobilization for Social Development

Research Note

Fiscal Capacity and Aid Allocation: Domestic Resource Mobilization and Foreign Aid in Low-Income Countries

Aniket Bhushan and Yiagadeesen Samy

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Do fiscal capacity and performance in developing countries have an impact on donor aid allocations?

The international community is increasingly recognizing the importance of domestic resource mobilization (DRM). Donors themselves have committed to explicitly link aid to taxation and the tax effort made by partner countries, confronted with the argument that high levels of aid dependence could undermine good governance by shifting political accountability from domestic to donor constituencies. Yet, the aid allocation literature has largely ignored taxation as an independent variable in explaining aid flows.

In their paper on fiscal capacity and aid allocation, the authors examine the interaction between fiscal performance and donor aid allocation, conducting a series of large-N regression analyses to unpack the determinants of donor aid allocation. The authors complement this statistical approach with an analysis of descriptive data that discusses recent fiscal performance data and donor involvement in taxation and public financial management in four project case study countries: Bolivia, Guatemala, Uganda and Zimbabwe.[1]

Neglecting tax performance in aid allocation

The results from the analysis show that donors—whether bilateral or multilateral—have paid little attention to fiscal capacity in their aid allocation decisions, despite the rhetoric on the importance of DRM. In general, more democratic countries tend to be rewarded with more aid, and countries with better institutions and policies receive more bilateral aid. For aid disbursement at the bilateral level, none of the fiscal capacity variables considered are found to be significant, indicating the absence of any relationship between aid received and tax performance. In the case of multilateral aid, per capita income and the level of democracy are significant in a few cases but the fiscal capacity variables are generally not significant. As for aid that goes towards public finance management (PFM) systems the authors find—contrary to expectations—that countries with more open trade regimes tend to receive less PFM aid. They also find no evidence that fiscal capacity is more closely related with aid given to PFM systems.

[1] While the paper includes Guatemala as a Latin American case study, other papers in the PDRM project feature Nicaragua.

Incentivizing the mobilization of domestic resources?

Commitments to link aid disbursements to improved fiscal performance are both a reflection of frustration with low tax effort in many highly-aid reliant countries, as well as increasing concern with high levels of aid becoming a disincentive to DRM and tax effort. The findings from the second part of the paper highlight donors' perceptions of fiscal performance in the four case study countries. Uganda and Guatemala are marked by a low tax effort index[2] and relatively low tax collection levels. While Bolivia displays a high tax effort, collection is low, whereas in Zimbabwe (perhaps surprisingly but based on the data available) a high tax effort is accompanied by high collection levels. However, among the case studies Uganda stands out as the largest aid recipient. Bolivia, Guatemala and Zimbabwe have never received even half the amount Uganda gets from donors. The country also receives the highest levels of aid specifically aimed at the PFM sector. Among the four case studies, it has the largest number of donors engaged in PFM support.

Neglecting recipient country priorities

How does this relate to perceptions of PFM systems by donors? Donors perceive the quality of Bolivia's PFM systems to have remained static between 2005 and 2010, while the perception of the reliability of Uganda's PFM systems during the same period deteriorated. Interestingly, donors have at the same time been providing significant support to building PFM capacity in Uganda. For the other two case studies, Guatemala and Zimbabwe, aid to the PFM sector is less significant. Despite repeated assertions regarding adherence to internationally agreed aid effectiveness principles that include commitments on alignment with recipient country priorities and channelling aid through country PFM systems, there remain large gaps in terms of delivering on these commitments.

Stepping up and linking aid disbursements to institutional performance

The level of overall aid to improve fiscal performance and tax effort in recipient countries remains very low. Given the importance of taxation to state-building, good governance and ultimately domestic accountability, donors need to devise creative ways of stepping up support for building good tax systems. The authors recommend a graduated approach that considers revenue or institutional performance indicators as incentives for aid disbursements.

Increasing tax mobilization

Given their classification as low effort and relatively low collection countries, both Guatemala and Uganda should be able to increase tax mobilization further without undermining other objectives such as growth and investment, by more fully capturing the potential tax base. Beyond structural characteristics, this would require overcoming political economy dynamics that could constrain tax mobilization.

Aligning aid with national priorities and securing domestic ownership

There is a danger that the complex process of building key government infrastructure and a better state-citizen compact will be reduced to quantitative targets in the implementation of the post-2015 development agenda. But taxation and DRM are as much about *how* revenue is collected as they are about *how much* is collected. Aid cannot 'buy reforms' that are not aligned with domestic incentives. One effective investment could be to create knowledge and information sharing platforms amongst various donors on their experience in supporting tax capacity. Similarly, continued and increased support for South-South platforms, such as the African Tax Administration Forum and similar initiatives in Latin America and Asia, could have important longer term effects.

[2] Rather than the commonly-used tax to GDP ratio, the authors use an index of tax effort, which controls for known factors that could affect taxation.

Need for a tax data revolution

Taxation needs its own data revolution to improve the availability and consistency of basic information. Donors have a role to play in this regard, as they have already done by investing in other data initiatives. Such initiatives need to be maintained in the long term, they need to avoid duplication, inconsistencies and fragmentation and they require increased support to enable informed discussions.

The paper on which this Research Note is based is available at www.unrisd.org/bhushan-samy

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