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Does Aid Discourage Domestic Revenue Mobilization?

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Some in the donor community and multinational financial institutions express concern that aid discourages the effort of governments in recipient countries to mobilise domestic revenue, and in particular to collect taxes. Researchers at the IMF in particular argue that governments that receive aid in the form of grants exert less tax effort than if aid is given as a loan. They support this claim with data that shows a clear correlation across aid recipients between high grants and low tax to GDP ratios.[1] This argument is appealing to many as if a government gets free money (aid grants) surely they would not try as hard to raise politically if not economically costly domestic tax revenue. If the aid is given as a loan the government knows it has to be repaid in the future so do have an incentive to raise tax revenue.

The empirical evidence is far from being as conclusive as the IMF researchers think. It is the case that developing countries with relatively low tax to GDP ratios tend to receive more aid relative to GDP, and that this aid is more likely to be in the form of grants (rather than loans). This is not surprising as low income countries tend to have a small tax base and hence low tax revenue relative to their spending needs, which is one of the reasons they receive aid (because donors accept their need to spend at levels above their tax revenue). The reason these countries have a small tax base is because they are poor (and poverty is also the reason they receive grant aid): the formal wage sector accounts for a small share of employment as most workers are in the informal or agriculture sectors, with low earnings that are difficult to tax or below any reasonable threshold for tax liability.

This pattern will persist even when one allows for the tax base. The tax performance literature seeks to explain the tax/GDP ratio as due to proxy measures of the tax base: the level of GDP (tax collection efficiency should increase as the economy grows), the sector share of agriculture (associated with a lower tax ratio) and of manufacturing (associated with a higher tax ratio), and the volume of international trade (as trade taxes are especially important in low income countries). Allowing for these factors, some countries will have lower tax (to GDP) ratios but higher aid than others for a variety of reasons. Poorer countries have smaller tax bases, so a lower tax/GDP ratio, but receive more aid (especially in the form of grants) because they are poor. The proxy measures of the tax base are not very accurate and a country's income level is only one factor determining how much aid it receives so there is an inherent tendency for a strong negative correlation between the amount of (grant) aid received and the tax/GDP ratio. This correlation itself tells us nothing about how aid may affect the behaviour of governments in raising tax revenue. Aid may be a factor affecting the tax ratio but separating 'cause and effect' is so difficult as to be almost impossible. In the following section, we consider why governments may relate aid and taxation in the way they behave.

Aid and the Politics of Taxation

Why should aid reduce tax effort? A common argument is that there is a political cost in raising taxes; nobody likes paying taxes so why would governments expend political effort in collecting taxes if they can get the money from donors? While this is no doubt true, there is also a political cost in accepting aid, and governments are unlikely to want to be very dependent on aid. The question then becomes: Is the political cost of aid lower than that of taxes? It does not seem obvious that it would be.

There are three main types of political costs that can be distinguished for aid and tax: bureaucracy, accountability and autonomy. The bureaucratic costs are those involved in the tax administration compared to the costs of officials from various ministries, especially Finance, interacting with donors. The latter is high but is a function more of the number of donors than the amount of aid, except insofar as donors that provide more aid are likely to demand more time from officials. Once a revenue authority is established there are incentives to increase tax collection. Many low income countries, especially in Anglophone Africa, have established semi-autonomous revenue authorities for precisely this reason. The bureaucratic costs of taxation are unlikely to be higher than those of aid once the revenue authority is in place.

The costs of accountability relate to the pressure perceived by the government in accounting for how it uses the money and are likely to be greater for aid. Donors exert effort to monitor use and to ensure the government can account for the use of aid (as the donor agency is accountable to its own constituency). They also attach conditions and even if the government does not comply with conditionality effort has to be expended in negotiating and, where applicable, in avoiding compliance. In contrast, accountability to taxpayers is very weak in the low income countries that are the major recipients of aid. Indeed, it can be argued that this lack of domestic accountability weakens the legitimacy of the state.

[1] For example, Benedek *et al.* (2012), Foreign Aid and Revenue: Still a Crowding Out Effect? *IMF Working Paper 12/186*.

The costs of accountability are likely to be higher for aid than for taxation, at least where the tax system is weak and revenues are relatively low.

The costs of autonomy lie in its absence: an autonomous government is one that can make independent decisions and policy choices. A government that is dependent on aid cedes some influence to donors; even if conditionality is not fully effective it acts as a constraint on policy action. A government with more domestic revenue has greater autonomy. Accountability relates to autonomy as the issue is to whom and to what extent the government is accountable, with accountability to domestic constituencies implying greater autonomy. Governments dislike ceding autonomy to foreign influences so politically taxes would be preferred to aid.

This may appear like a very long and even convoluted way of arguing that aid is not likely to reduce tax effort but actually explains why this is the case. In general, governments would prefer to mobilise domestic revenue than accept aid because the political costs of aid are higher. Low income countries continue to rely on aid because they are constrained in their ability to raise sufficient domestic revenue to meet their expenditure needs (and note that expenditure generates political gains – public services and jobs are liked).

Aid and Mobilizing Tax Revenue

What does the empirical evidence show? At face value it may appear to suggest that aid does reduce tax effort: countries that receive relatively large amounts of aid tend to have relatively low levels of tax revenue (where both are measured as a share of national income). This is merely a correlation: it is as plausible that low tax is the reason for high aid as it is to argue that high aid is the reason for low tax. In practice both are determined by a third factor, low income. Fundamentally, it is the characteristic of being a poor country that generates the observed correlation between high aid (and grant aid) and low tax. As countries experience economic growth and move from low to middle income status one typically observes a corresponding increase in tax revenues (as the tax base expands) and a decline in aid (as need diminishes).

Once this natural correlation is accounted for there is evidence that aid has been associated with increases in tax/GDP ratios over the past 20 or so years[2]. Identifying reasons for this provides lessons for using aid to support tax revenue mobilization. The use of the term ‘aid’ is somewhat misleading in suggesting the effect on tax is due to the amount of aid. In practice, it is the donor-recipient relationship, supported by aid but including technical assistance and policy reform conditions, that affects tax revenue. In the context of this broader interpretation of aid, there are three principal lessons.

- Administrative support and institutional reform can be the most effective way of increasing tax revenue. Donors can provide valuable support for the design and implementation of tax policy reforms, establishing independent revenue authorities, and improving processes to monitor tax administration and increase collection efficiency, thereby reducing the bureaucratic costs of taxation.
- If donors recommend policy reforms that are likely to reduce tax revenue they should propose complementary measures to make up the revenue shortfall. A good example is trade liberalization as this entails reducing tariffs and can have an immediate effect of reducing tax revenue. Tariffs are administratively and politically easier to collect than VAT or income taxes so from a revenue perspective it would be better to have alternative taxes in place prior to significant tariff reductions. Implementing new taxes or increasing revenue from existing non-trade taxes should be in conjunction with promoting accountability, which favours more visible income taxes over less visible sales taxes.
- To the extent that aid contributes to economic growth, better governance and improved institutions it fosters an environment for increased tax/GDP ratios which promotes autonomy. In conjunction with tax and fiscal (expenditure monitoring) reforms that increase accountability this can enhance the fiscal legitimacy of the state. In simple terms, effective aid is consistent with increasing tax revenue and reducing dependency on aid. ■

Literature

Further details on the issues covered can be found in:

Morrissey, O. (2012), ‘Aid and Government Fiscal Behaviour: What Does the Evidence Say?’ Helsinki: WIDER Working Paper No. 2012/01 (at www.wider.unu.edu).

Prichard, W., J-F. Brun and O. Morrissey (2012), ‘Donors, Aid and Taxation in Developing Countries: An Overview’, International Centre for Taxation and Development (ICTD): ICTD Working Paper 6 (at www.ictd.ac).

[2] See Clist, P. & Morrissey, O. (2011), Aid and Tax Revenue: Signs of a Positive Effect Since the 1980s. *Journal of International Development*, *23* (2), 165-180