

Interaction of Tax and Aid



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- Relevance
- Trends in tax revenues and aid flows
- Empirical findings
- Another dimension
- Policy conclusions

- Net foreign aid to developing countries has averaged between 3.7% and 6.7% of GDP during 1980-2009
- Net foreign aid has averaged between 20% and 40% of tax revenues
- Concern in the literature about
 - aid dependency

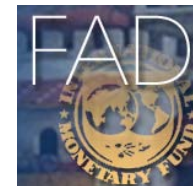
- Impact of uncertain aid on budget planning
- Impact on incentives to strengthen tax systems (by promoting rent seeking) and to build institutions
 - Thus aid can substitute for domestic revenues
- The implications of aid substitutability are:
 - Aid can adversely affect fiscal consolidation efforts through reduced revenues
 - More than estimated resources would be needed for MDGs; and
 - Shift the burden of taxation to donor countries

Trends in Tax Revenue and Net Aid

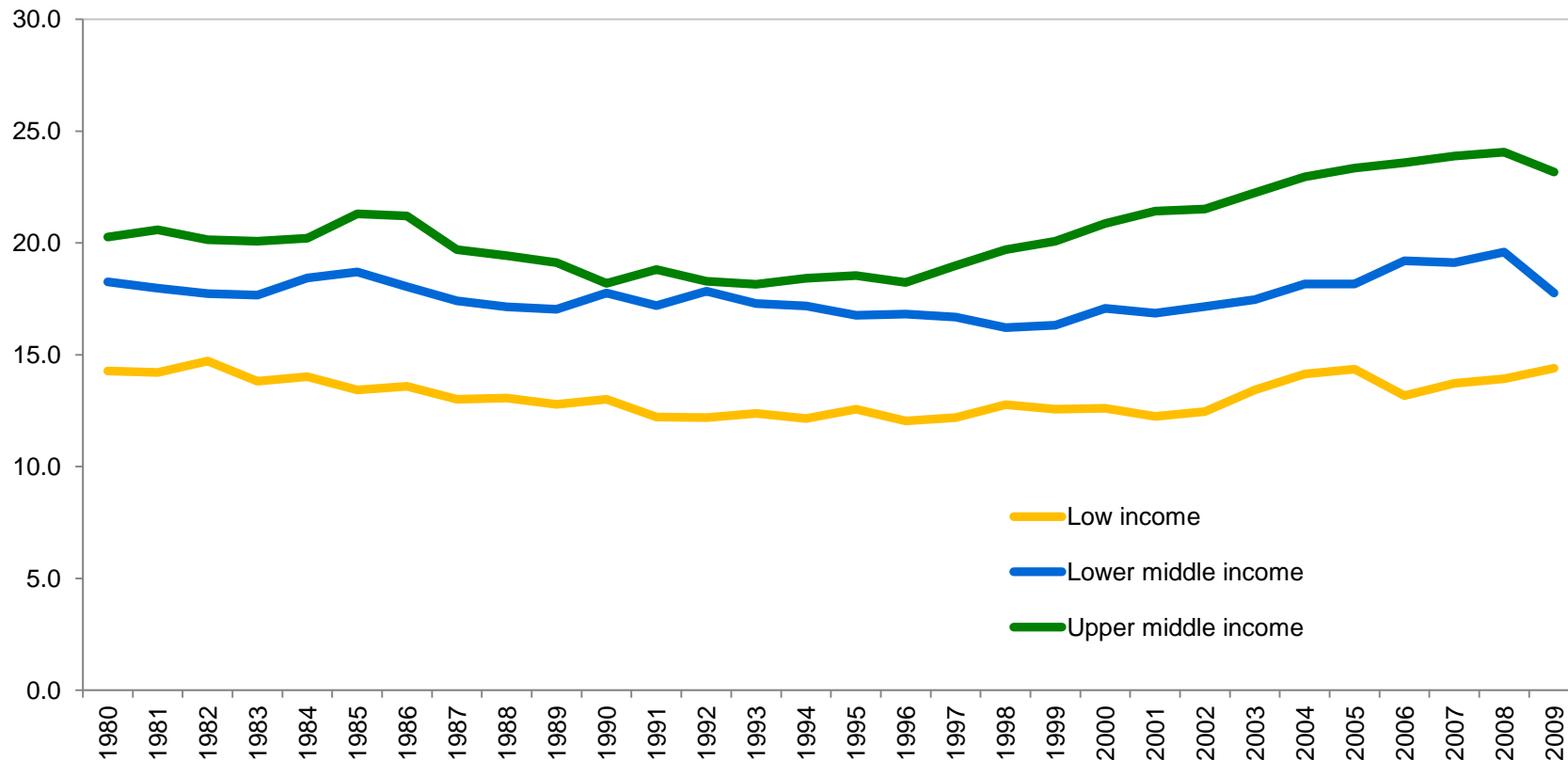


- Tax revenue in low- and middle-income countries, 1980-2009

...Tax Revenues Have Remained Broadly Stable in Two Groups



Average Total Tax Revenue % GDP

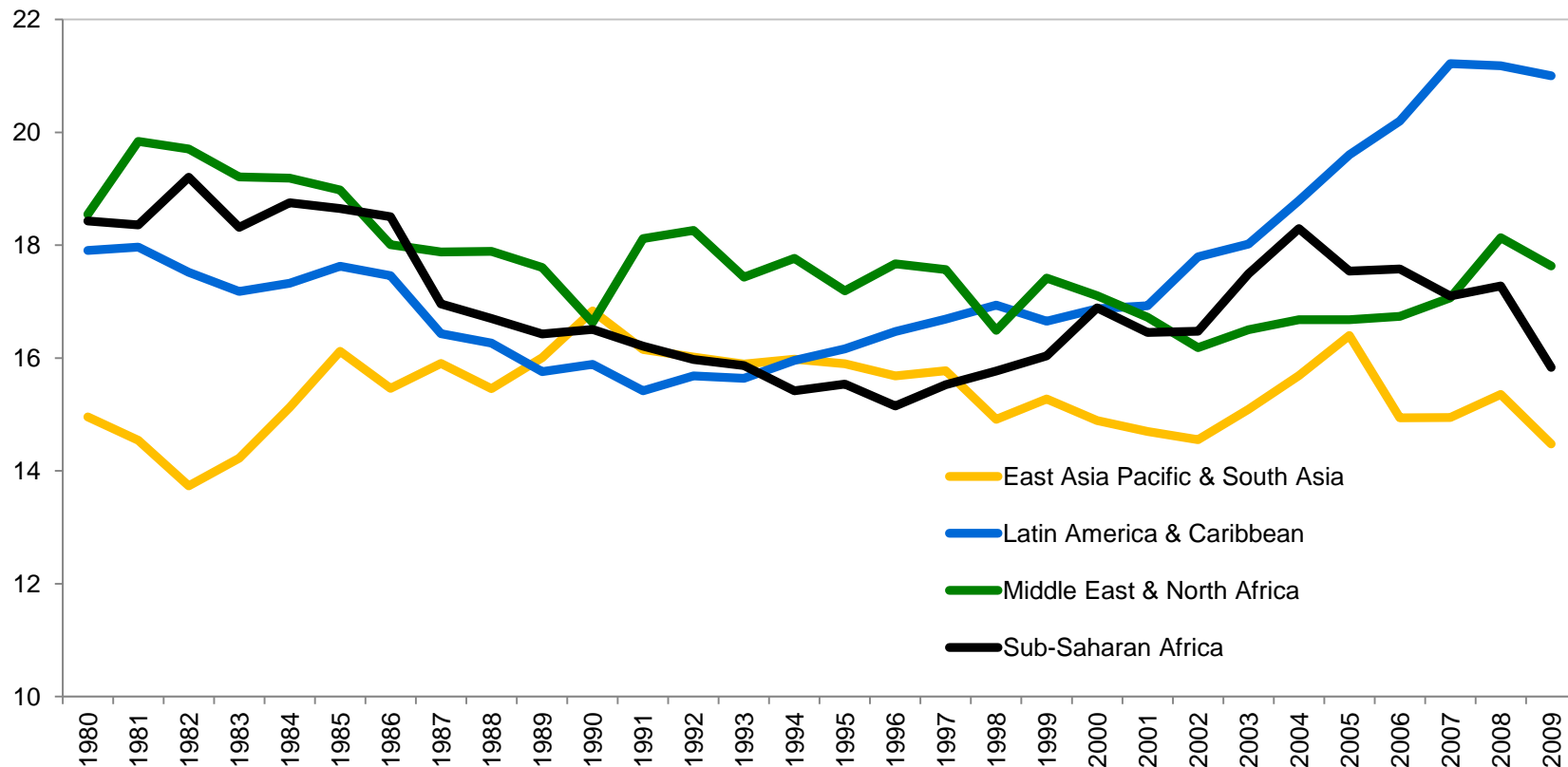


Note: Economies are divided among income groups according to 2009 gross national income (GNI) per capita, calculated using the World Bank Atlas method. The groups are: low income, \$995 or less; lower middle income, \$996–3,945; upper middle income, \$3,946–12,195.

.... Little Progress in Three Regions



Average Total Tax Revenue % GDP

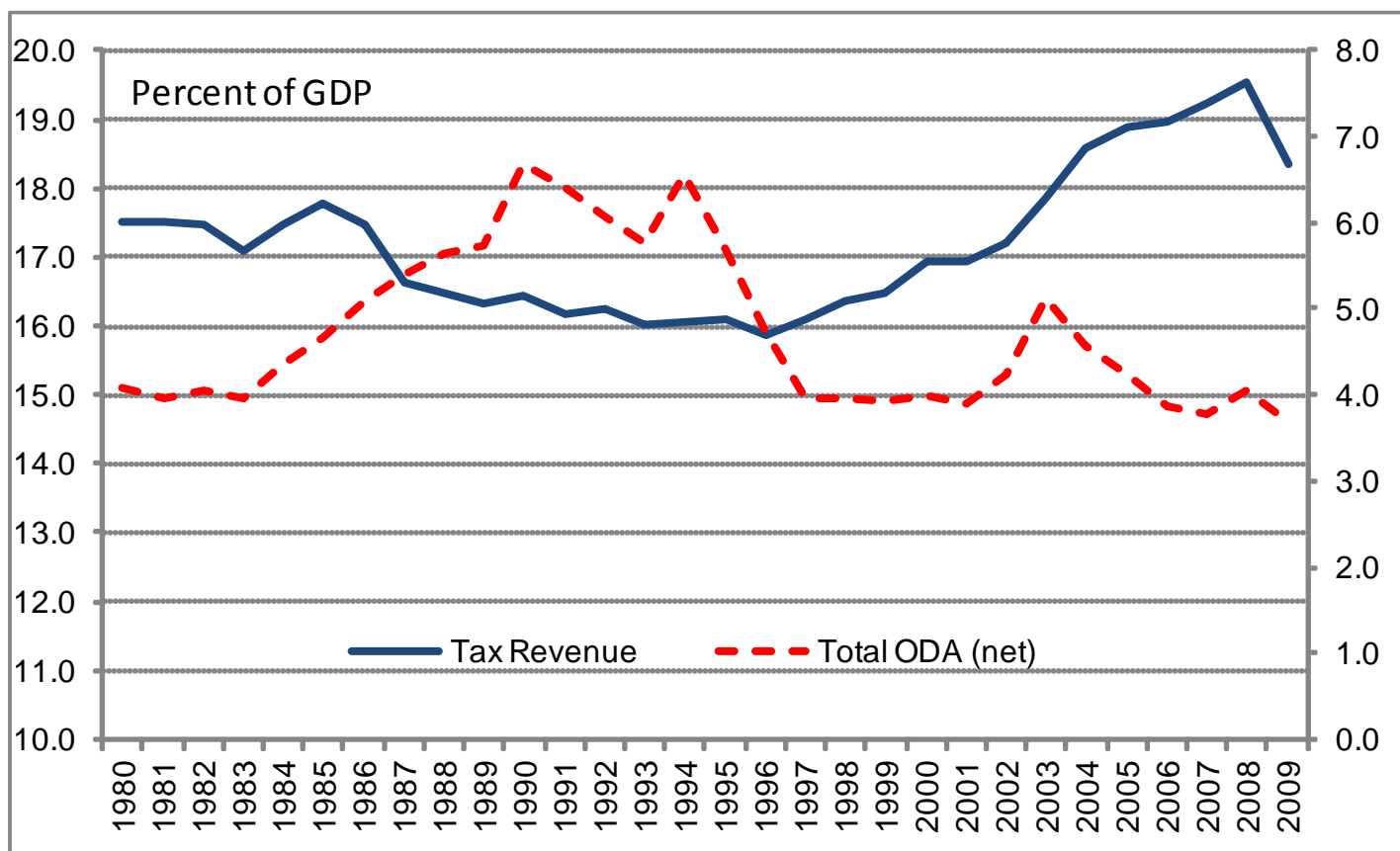
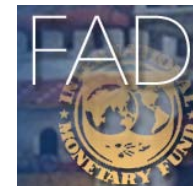


Trends in Tax Revenue and Net Aid



- A simple plot suggests a negative association between net ODA and tax revenues

Average Net ODA and Tax Revenue in Low and Middle Income Countries, 1980-2009



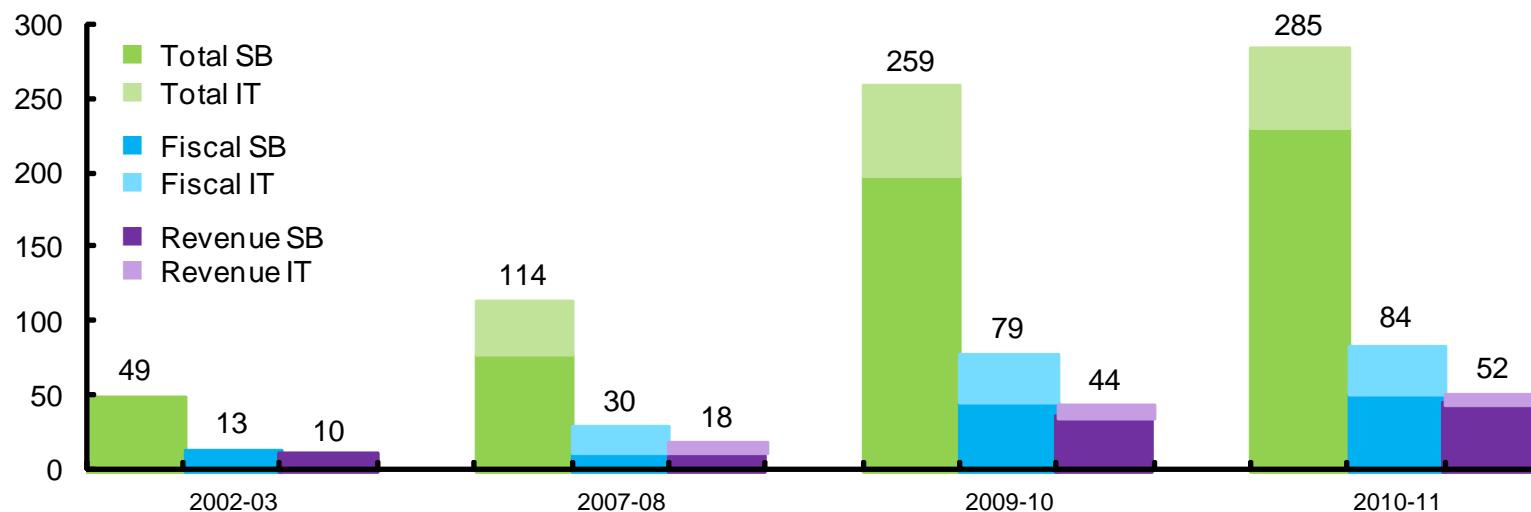
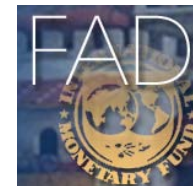
Note: Tax revenue is measured on the left axis, while total ODA is measured on the right axis.

- Studies are split between negative and positive effects of aid on domestic revenue mobilization
- Some studies have also examined the relative effect of grants and loans on the domestic revenue performance
- The assumption is that recipients view grants and loans differently

- The earlier results showed that a dollar increase in overall aid (net loans and grants) was associated with a decline in domestic revenues
- The composition of aid also matters
- ODA in the form of loans is associated with higher tax revenues; converse holds for grants
- These results were challenged in more recent studies

- However, the results using updated data and that address many of the criticism support the previous conclusions
- But the impact is weakening (the offset for grants was 28 percent for every dollar. It is now 8 percent)
- Why?
 - Countries are making efforts to raise more revenue given pressing needs
 - Figure 2 shows structural benchmarks and indicative targets in the IMF-supported programs for low-income countries since 2002-2003

Structural Benchmarks and Indicative Targets



Notes:

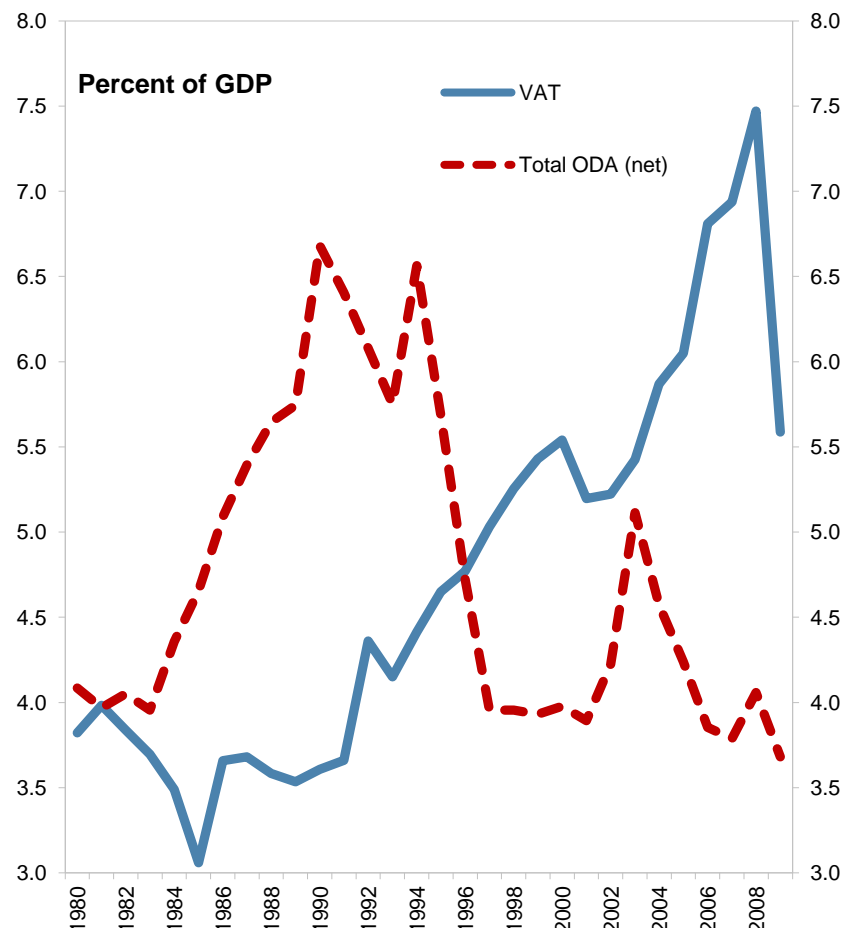
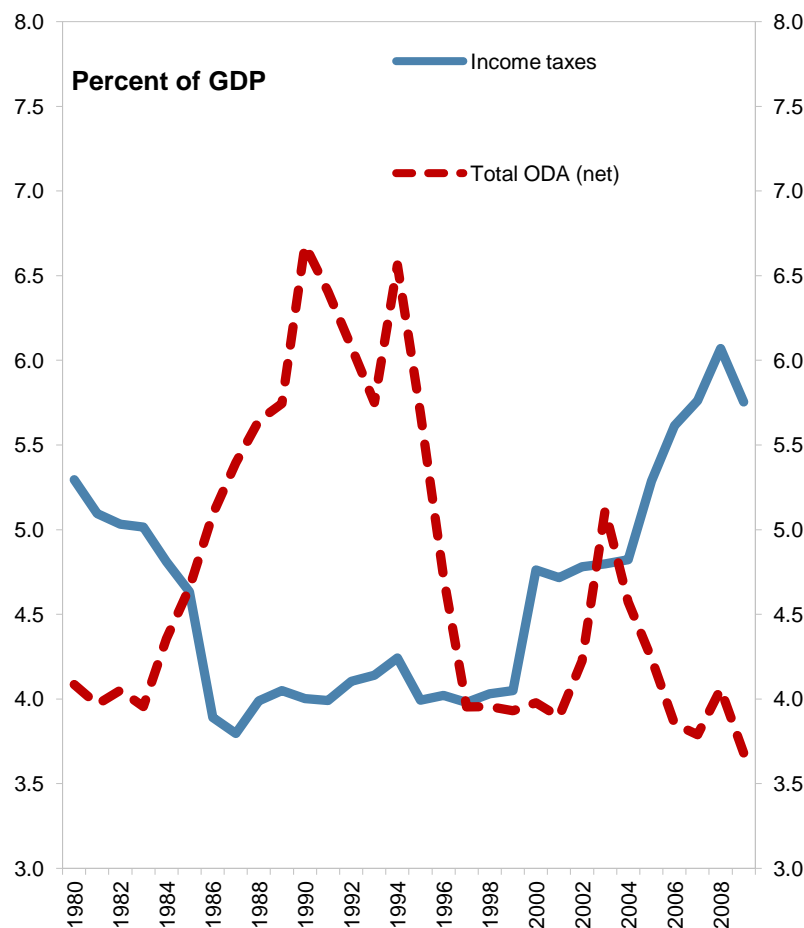
Indicative targets (IT) refer to quantitative targets that the program is designed to achieve, but is not a prerequisite for continued disbursements. e.g., Fiscal deficit, Floor on revenues, Floor on priority spending

Structural benchmarks (SB) can be legal, institutional or policy measures that are relevant for a program's macroeconomic objectives. e.g., Introduction of Tax Identification Number, Increase of VAT Threshold, Establishment of a Large Taxpayer Unit, Reduction/elimination of tax exemption

Source: IMF

- Does the above inverse relationship hold when we disaggregate tax revenues? No study has done this until now
- First, plots of different tax revenues and net ODA

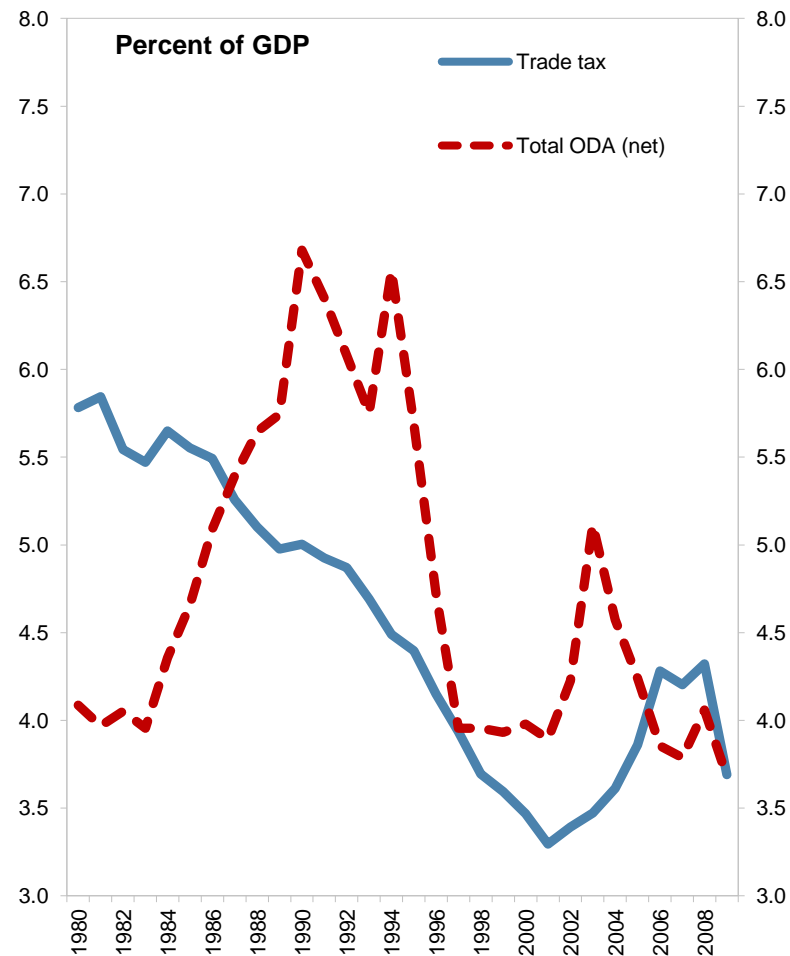
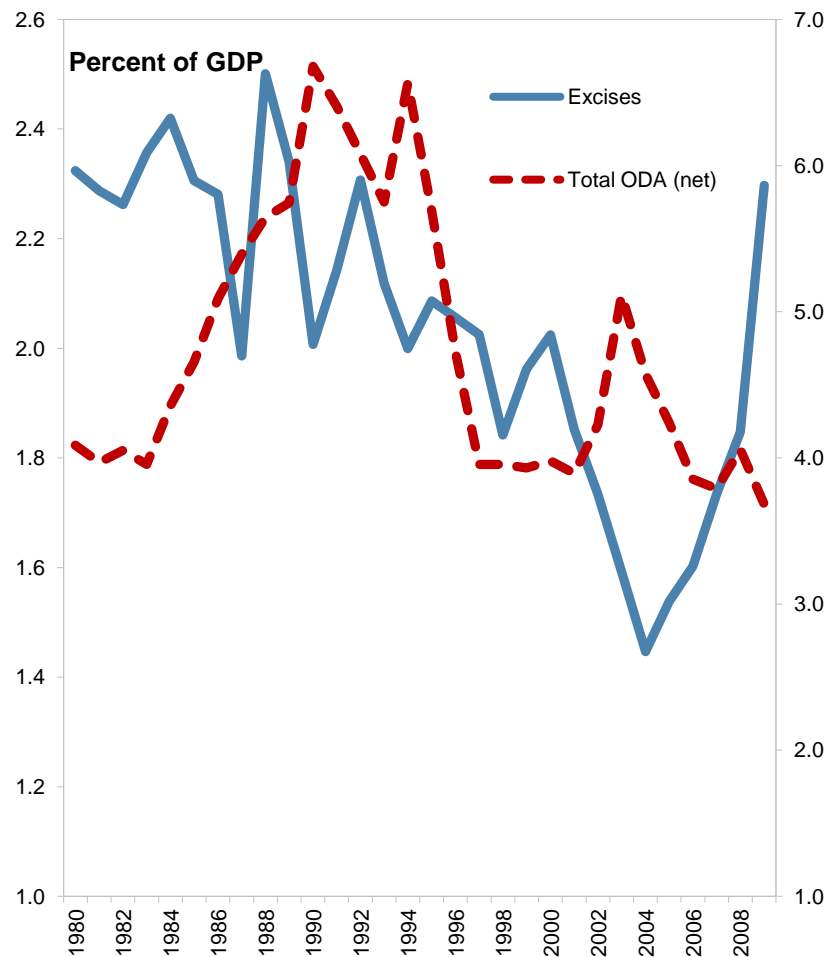
Average Taxes and Total Net ODA, 1980-2009



Note: Tax Revenues are measures on the left axis and Total ODA on the right axis.

Source: Author's calculations based on the IMF's FAD Revenue Mobilization database and OECD DAC database

Average Taxes and Total Net ODA: 1980-2009



Note: Tax Revenues are measures on the left axis and Total ODA on the right axis.

Source: Author's calculations based on the IMF's FAD Revenue Mobilization database and OECD DAC database

- The results show that net aid has a negative relationship with VAT, excise and income taxes
- Grants are negatively associated with these taxes with the offset of 12 percent for VAT—the highest among the three taxes
- Significant revenue potential has been estimated from strengthening VAT productivity, adjusting excises, and eliminating tax exemptions
- But ODA is positively associated with trade tax revenues

- Disaggregating the sample shows that results hold for countries in sub-Saharan Africa and for low-income countries
- However, a higher level of grants ends up almost fully displacing domestic tax revenues in countries with weak institutions
- These results are similar to those in the previous study

- Similar results hold for hydrocarbon producers
- An additional percentage point of revenue from hydrocarbons reduces revenues from other domestic sources
- Interestingly, the effect of grants on non hydrocarbon revenues is negative.

- Despite some success cases (e.g. Tanzania, El Salvador, Vietnam) domestic resource mobilization continues to be below potential in many countries
- Aid flows can influence the incentive structure of aid recipients and empirical studies show that is the case in SSA and low-income countries in particular
- The impact is relatively large for VAT

Policy Conclusions



- The good news is that the overall impact is modest and weakening for countries with relatively strong institutions
- This reflects increasing attention being paid to revenue mobilization under reform programs in many countries
- However, the continuing almost full displacement of domestic tax revenues in countries with weak institutions is a source of concern
- Finally, the negative relationship between hydrocarbon revenues and other domestic revenues found in natural resource producers suggests that these countries will face significant costs in moving to a higher level of domestic taxation once domestic resources are depleted



Thank you!

Country Income Categories



Low income

Bangladesh, Benin, Burkina Faso, Burundi, Cambodia, Central African Rep., Chad, Comoros, Congo, Dem. Rep. of, Eritrea, Ethiopia, Gambia, The, Ghana, Guinea, Guinea-Bissau, Haiti, Kenya, Kyrgyz Republic, Lao People's Dem. Rep, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Sierra Leone, Solomon Islands, Tajikistan, Tanzania, Togo, Uganda, Zambia, Zimbabwe

Lower middle income

Angola, Armenia, Belize, Bhutan, Bolivia, Cameroon, Cape Verde, China, P.R.: Mainland, Congo, Republic of, Côte d'Ivoire, Djibouti, Ecuador, Egypt, El Salvador, Georgia, Guatemala, Guyana, Honduras, India, Indonesia, Jordan, Kiribati, Lesotho, Maldives, Moldova, Mongolia, Morocco, Nicaragua, Nigeria, Pakistan, Papua New Guinea, Paraguay, Philippines, Samoa, Senegal, Sri Lanka, Sudan, Swaziland, Syrian Arab Republic, São Tomé & Príncipe, Thailand, Tonga, Tunisia, Ukraine, Uzbekistan, Vanuatu, Vietnam, Yemen, Republic of

Upper middle income

Albania, Algeria, Antigua and Barbuda, Argentina, Azerbaijan, Rep. of, Belarus, Bosnia & Herzegovina, Botswana, Brazil, Bulgaria, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Fiji, Gabon, Grenada, Iran, I.R. of, Jamaica, Kazakhstan, Lebanon, Libya, Lithuania, Macedonia, FYR, Malaysia, Mauritius, Mexico, Namibia, Panama, Peru, Russian Federation, Seychelles, South Africa, St. Kitts and Nevis, St. Lucia, St. Vincent & Grenadines., Suriname, Turkey, Uruguay, Venezuela, Rep. Bol.

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