Chapter 1

Introduction

This introductory chapter first sets the scene for the discussion of aid modalities that donors may use to support tax systems. It states the context, motives, and objectives behind this book and, importantly, considers some definitions of "aid modality". It seeks to explain why a study of development assistance for tax systems is topical – prompted by a surge of interest in domestic revenue raising that has brought taxation out of the shadows of development assistance and made it a mainstream priority target. The chapter then goes on to describe the research methodology underpinning the study, which draws on the literature, a survey, and the experience of selected countries. It then outlines the study's scope, structure, and objectives.

A growing number of international aid agencies are recognising that taxation is an important mainstream priority for development assistance (International Tax Compact, 2010ab; Michielse and Thuronyi, 2010). Yet, until recently, the issue was neglected. The conditions attached to the Heavily Indebted Poor Countries (HIPC) initiative, for example, focus on expenditure for poverty reduction. Similarly, the indicators for monitoring progress towards the Millennium Development Goals highlight the provision of social services. According to the OECD, tax programmes accounted for less than 0.1% of overall Official Development Assistance (ODA) in 2009.[1]

Two main factors have driven the recent change in attitudes. First, there has been a groundswell of interest in mobilising domestic resources as a foundation for sustainably funding essential public services and eventually exiting aid dependency. The need to raise domestic revenue through efficient tax systems was a fundamental objective of the 2002 *Monterrey Consensus on Financing for Development* (United Nations, 2003). The issue received a new lease of life from the fiscal problems that many donor countries themselves have experienced in the wake of the global financial crisis. The second factor is that the international community is increasingly coming to recognise that the development of an effective, efficient, equitable tax system is a central pillar of state building and good governance.[2]

These two factors have strongly reinforced the traditional technical tax reform agenda. It focuses firmly on macroeconomic balances and the effects of the tax system on investment, efficiency, job creation, and sustainable growth to reduce poverty and mobilise domestic resources.

Purpose and scope of the study

The core theme of this study is the need for efficient, effective aid modalities (Box 1.1) to support tax systems in developing countries and promote the twin goals of revenue mobilisation and good governance as the cornerstones of sustainable development.

Box 1.1. **What is an "aid modality"?**

The term "aid modality" is synonymous with "aid instrument". No definition is given in the on-line OECD Development Assistance Committee (DAC) Glossary. However, a Danish glossary cites DAC in defining the term simply as "the way donor support is channelled to the activities to be funded". This includes: "1) budget support (which is integrated into the national budget of the recipient country …), 2) parallel support (which is kept separate from the general resources in the national budget …), and 3) in-kind support (… in the form of goods or services)."

Source: Ministry of Foreign Affairs of Denmark, Aid Management Guidelines Glossary (http://amg.um.dk/en/servicemenu/Glossary/Glossary.htm.).

More specifically, the purpose of the study is to review theoretical insights and the lessons of experience in the search for practical recommendations on the use of aid modalities to further revenue mobilisation and good governance. To that end and in line with tasks set out in its terms of reference, the study examines some of the following questions:

- What are the goals and key elements of a governance-focused tax reform agenda?
- What areas should revenue mobilisation programmes prioritise to pay dividends for governance?

- What aid modalities are used to support tax programmes? How can their design be improved? How can their approaches be more closely harmonised and aligned?
- Are there lessons that can be learned so that aid modalities co-operate more closely in supporting programmes to improve tax systems? What are those lessons?
- What are the preconditions and design recommendations for effective use of basket financing?
- What types of activities are most important to fund?
- How do country-specific factors influence or constrain the nature of donor support?
- What is the role of international or regional entities and standards?
- What issues are priorities for further discussion and analysis?

Given the scope and complexity of the issues, this necessarily limited study addresses some aspects more briefly than others. The discussion can, for example, only touch on country-specific factors affecting donor support as a detailed analysis would require separate studies (*e.g.* USAID, 2008). Similarly, although local government revenue systems are extremely important to both the tax and governance agenda (Bahl, 2010; Chambas, 2010), they cannot be addressed in detail here. Among the major topics beyond the scope of the study are the management of natural resource revenues (Daniel *et al*., 2010) and cross-border tax issues, which are addressed in numerous OECD documents.

This study does not try to re-invent the wheel in evaluating the various aid modalities, technical approaches to tax reform, or the relationship between taxation, governance, and state building. Ample literature is already available. Instead, the focus is on how aid modalities can best be used to support tax systems and enhance the linkages between taxation and governance. The study also seeks to enrich the literature on taxation and governance by distinguishing points of synergy and divergence between the technical and governance agendas for tax reform.

A final point is that there are many variations on each modality theme and a great diversity of country conditions, needs, and solutions. In practice, the "best" approach to virtually every issue is particular to a time and place. The aim, then, is not offer pat solutions, but rather to contribute to the international dialogue on aid modalities to improve tax systems and promote good governance.

Methodology

This report draws on three sources of information: a review of the literature; a survey of aid agency officials; and selected case studies. The literature review covers recent academic literature and many other documents from multilateral and bilateral organisations (see "References" at the end of each chapter). The review focuses on aid effectiveness, donor modalities for supporting tax systems, the relationship between revenue mobilisation and governance, and tax reform priorities in developing countries.

The study team also sought lessons from experience through a survey of officials who had worked with tax programmes in major bilateral and multilateral organisations, regional entities, and non-governmental organisations. The team conducted their survey through structured interviews to gather information on each organisation's involvement with tax issues; areas of programmatic focus or comparative advantage; experience with modalities

in harmonising and aligning support for tax systems; governance dividends from tax programmes; conditions for success (or failure); and ideas for further study. Where possible the interviews were face-to-face, but most involved telephone discussions and follow-up by email, as the budget had no provision for field visits.

The study gives special attention to six country cases, based on a review of documents and phone interviews with aid officials and (where possible) government officials who have direct experience in dealing with aid modalities to support the tax system in their country. The chosen countries are Ghana, Guatemala, Liberia, Mali, Mozambique, and Tanzania. The time constraints were such that the case studies have not produced in-depth reports. The aim is, rather, to offer a ground-level view of how various aid modalities work in practice, along with information on tax reform priorities and tax-governance linkages. Indeed, the study's terms of reference state that it is "not an exhaustive assignment" but one that is designed "to provide examples" from various regions and country types. Accordingly, the study team chose the case-study countries against five criteria:

- the potential for learning lessons about effective multi-donor approaches to supporting tax systems;
- the extent of donor support, particularly with multi-donor involvement;
- coverage by region (with a main focus on Africa) and country type (one post-conflict case);
- recommendations from consultation with the German development bank, Kreditanstalt für Wiederaufbau (KfW), and the OECD/DAC GOVNET Taxation and Governance Task Team; and
- availability of information.

To broaden the range of experience examined and support the analysis and recommendations, this study also draws on a review of the literature and survey interviews for information on other countries. Text boxes feature insights from Uganda, Afghanistan, Kenya, El Salvador, and South Africa.

Assessments of aid modalities use five benchmarks drawn from the principles of the 2005 *Paris Declaration on Aid Effectiveness*: ownership; alignment; harmonisation; managing for results; and mutual accountability. The discussion also explores areas in which the Paris criteria may give rise to trade-offs. For example, where host-country systems are very weak, full alignment would not be the most efficient or effective use of tax system aid. Similarly, in cases where the preferences of senior tax officials are heavily influenced by past practices and institutional inertia, managing for results may require that donors exercise knowledge leadership rather than simply aligning programmes on local priorities. In essence, the Paris principles are guidelines for improving aid effectiveness, not ends in themselves.

Structure of the study

The report is organised as follows. Chapter 2 provides an overview of the literature on taxation and governance. It highlights the broad areas of synergy between the governance agenda and the standard technical agenda for tax reform, while also looking at some important points of divergence.

Chapter 3 assesses the main modalities used to support tax systems, including budget support programmes and their role in promoting revenue objectives. It proposes a short

definition and general description of each modality in accordance with the principles of the *Paris Declaration on Aid Effectiveness*, assesses its applicability for supporting tax systems and tax-governance linkages, then draws conclusions for consideration by donors and host governments.

Chapter 4 briefly discusses the question of what to support, as distinct from the main topic of how to provide support. It then addresses five implementation issues raised repeatedly during research for the study and which transcend all aid modalities: the identification of programmatic priorities for tax reform; the development of diagnostic tools; the selection of revenue indicators; the division of labour between aid agencies in supporting tax systems; and conditions for exiting from such support. Chapter 5 is devoted to the six country case studies which offer practical illustrations of the aid modalities discussed in the second, third, and fourth chapters. Chapter 6 closes the study with a set of broad conclusions and a summary of the chief findings and recommendations.

Supplementing the study are four annexes. Annex A lists persons interviewed and other contacts who provided information or comments. Annex B presents the survey questionnaire used to obtain feedback on aid modalities and tax-governance linkages, while Annex C summarises the main findings from the survey. Finally, Annex D provides an empirical overview of tax performance in low-income and lower-middle-income countries, along with stylised facts on the relationship between taxation and governance.

Notes

1. Data provided by the OECD to the Tax and Development Task Force Subgroup on Taxation, State building and Aid, 12 January, 2011. The 0.1% cited does not include the IMF. Even within the category of bilateral aid for public administration, economic policy and public sector financial management, tax-related assistance accounted for just 1.7% of total funding in 2005 (OECD, 2008).

2. Another factor is an underlying concern that foreign aid itself may affect the incentives for host governments to raise revenue and accountability to their citizens. The empirical evidence of this hypothesis is inconclusive (Moss *et al*., 2008; Carter, 2010; von Haldenwang and Ivanyna, 2011), but this does not negate the concern.

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