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Fiscal Capacity and Aid Allocation *Domestic Resource Mobilization and Foreign Aid in Developing Countries*

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prepared for the UNRISD project on
Politics of Domestic Resource Mobilization

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Introduction to Working Papers on The Politics of Domestic Resource Mobilization for Social Development

This paper is part of a series of outputs from the research project on The Politics of Domestic Resource Mobilization for Social Development.

The project seeks to contribute to global debates on the political and institutional contexts that enable poor countries to mobilize domestic resources for social development. It examines the processes and mechanisms that connect the politics of resource mobilization and demands for social provision; changes in state-citizen and donor-recipient relations associated with resource mobilization and allocation; and governance reforms that can lead to improved and sustainable revenue yields and services. For further information on the project visit www.unrisd.org/pdrm.

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List of Acronyms

AEO	African Economic Outlook
CPIA	Country Policy and Institutional Assessment
CRS	Creditor Reporting System
DAC	Development Assistance Committee
DRM	Domestic Resource Mobilization
GFS	Government Financial Statistics
HC-IDC	House of Commons International Development Committee
IDA	International Development Association
IMF	International Monetary Fund
MDG	Millennium Development Goal
MCC	Millennium Challenge Corporation
NSI	North-South Institute
OECD	Organization for Economic Co-operation and Development
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
UNRISD	United Nations Research Institute for Social Development
USAID	United States Agency for International Development
VAT	Value Added Tax
WDI	World Development Indicators

Summary

This paper is part of a the UNRISD project on The Politics of Domestic Resource Mobilization (UNRISD 2012). Its specific contribution is with regards to the interaction between fiscal performance and donor aid allocation in developing countries. While several studies have examined whether aid affects fiscal performance, there has been no systematic study of whether fiscal capacity and performance in developing countries has any impact on donor aid allocation decisions. We argue that the latter is an important issue given that domestic resource mobilization (DRM) is being increasingly recognized as an important component of financing for development, and that some donors are beginning to pay more attention to taxation and fiscal capacity. After reviewing the fiscal performance and aid allocation literature, we discuss the results of a large N-analysis for the period 1992-2010 that augments a standard aid allocation model with fiscal variables. This preliminary analysis of overall bilateral and multilateral aid allocation leads us to conclude that there is hardly any correlation between overall aid and fiscal performance and capacity. We then complement this analysis by discussing the recent fiscal performance data and donor involvement in taxation and public financial management (PFM) in four case study countries. These case studies allow us to examine donor-recipient relationships. Specifically, we calculate a tax effort index for recipient countries over the period 1990-2012 and examine trends in various fiscal performance metrics. We also highlight which donors are present in the case study countries, and what their perceptions of fiscal performance in these countries are. Our analysis shows that there are important gaps in terms of donors delivering on their commitments to align with recipient country priorities and providing aid through country PFM systems.

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Introduction

This paper is concerned with the interaction between fiscal capacity and performance in developing countries on the one hand, and donor aid allocation on the other. We are interested in whether fiscal capacity and performance in developing countries has any impact on donor aid allocation decisions. Given that domestic resource mobilization (DRM) is now seen by the international community as an important component of financing for development, we attempt in this paper to conduct an empirical analysis of whether (and the extent to which) donors consider tax performance in aid allocation decisions.

In order to answer this question, the paper is divided into the following five sections. The next section sets out the rationale and motivation for the analysis in more detail. Section 3 reviews the fiscal performance and aid allocation literature, pointing out the contributions and gaps in the literature. Section 4 presents our empirical framework and discusses the results of several large-N regression analyses that augment a standard donor aid allocation model with fiscal variables. Section 5 discusses recent fiscal performance data and donor involvement in taxation and public financial management (PFM) in four case study countries (Bolivia, Guatemala, Uganda and Zimbabwe) that were selected for the UNRISD project on “The Politics of Domestic Resource Mobilization for Social Development” (UNRISD 2012). An examination of different cases allows us to answer our main research question by looking more specifically at donor-recipient relationships, which the large-N analysis (as a result of data limitations at the individual donor level) cannot do. In particular, we are able to calculate a tax effort index for recipient countries and examine trends in various fiscal performance metrics. We are also able to highlight which donors are prominent in our case study countries, and what their perceptions of fiscal performance in these countries are. A concluding section highlights key messages and findings, and suggests areas that require further research, especially for further examination of the cases using local knowledge.

Rationale and Motivation

While there is already a significant literature on aid allocation (which has tried to measure the extent to which aid is allocated based on recipient need and merit as opposed to donor self-interest), and a growing literature on whether high levels of aid are a disincentive to greater tax effort especially in highly aid reliant countries, the rationale for examining fiscal performance from the perspective of donor aid allocation is not obvious at the outset. In other words the main question here is not embedded in an

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